THE MARKET IMPACT OF THE PRESIDENT'S SOCIAL SECURITY PROPOSAL

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
FINANCE AND HAZARDOUS MATERIALS

OF THE

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THE MARKET IMPACT OF THE PRESIDENT'S SOCIAL SECURITY PROPOSAL

THURSDAY, FEBRUARY 25, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:20 a.m., in room 2123 Rayburn House Office Building, Hon. Michael G. Oxley (chairman) presiding.

Members present: Representatives Oxley, Gillmor, Greenwood, Cox, Lazio, Shimkus, Shadegg, Fossella, Ehrlich, Bliley (ex officio), Stupak, Luther, Markey, and Pallone.

Staff present: David Cavicke, majority counsel; Linda Dallas Rich, majority counsel; Brian McCullough, majority professional staff; Robert Simison, legislative clerk; and Consuela Washington, minority counsel.

Mr. OXLEY. The subcommittee will come to order, and before we recognize the members of the panel, there is a call for a floor vote.

So I would yield to the gentleman from Massachusetts for 5 minutes.

Mr. MARKEY. Thank you, Mr. Chairman, very much. I want to highly commend you for having this hearing. Key components for any Social Security reform legislation have to come through the aegis of this committee.

I am an advocate for investing a portion of the surplus in the private sector, and Mr. Bartlett and Mr. Pomeroy and I will be introducing a bill to do this in a fair and measured way this afternoon.

This idea has many detractors, and we will be hearing from some of them today. But to paraphrase Winston Churchill, investing a portion of the Social Security surplus in the private sector is the worst method of saving Social Security except all the other methods.

We could, of course, close the gap in some other way. For example, we could raise the progressive payroll tax or we could cut the benefits. But it is no accident that these alternatives have few political champions. After all, they both involve tipping people upside down and shaking money out of their pockets. The President's proposal to invest some of the trust money in the private sector closes that gap by another 6 years.

Critics of investing a portion of the surplus in the financial markets are frightened by these new potential dangers. One is the potential danger of gambling on a market that could crash. The second is the potential danger of political meddling in the economy.

Both of these concerns are valid, but their potential for materializing can be reduced to near zero by limiting the investment authority in important ways. It is certainly valid to be concerned about tying the level of an individual's benefit to the rise and fall of the market.

The stock market crash in 1929 was a defining event for the families of many of today's retirees, and they have a visceral negative reaction to giving up the current system, which guarantees benefits, in favor of a system in which benefits vary from the whims of what they view to be the stock market casino.

To reassure these anti-gamblers, we must not alter the fundamental guarantee of the Social Security system, that benefits will be maintained no matter what the condition of the economy on the day an individual retires.

That is the fatal weakness of the proposals to privatize Social Security, where the guarantee is either eliminated or reduced in favor of, well, gambling by individuals of a sort so aptly detailed in this morning's Washington Post. Such a system would no longer merit the term "security." Instead, it crosses that thin line between vision and vagueness.

Now, the concern about political meddling comes in two forms. First, great fear that this proposal will destroy the market simply because of the sheer size of the trust fund. But we are limiting the amount of the trust funds that could go into the markets to just 4 percent of the market, less than half of the amount currently accounted for by State and local pension funds.

Are critics of the President's proposal suggesting that we should ask the State and the local pension funds to no longer be in the market? I do not hear that suggestion. And they have at least twice as much as anything that is being proposed for the Federal Government.

Second, opponents say that this proposal would socialize our economy by allowing Federal ownership of corporate America, leading inevitably to meddling in the marketplace by politicians intent on disinvesting in tobacco or South Africa or unloading investment in housing in the inner city or in pockets of rural housing.

But at the Federal level, we have had a decade of experience under the Federal Employee Retirement System, FERS, with investment or choosing stock and bond index funds for investment by Federal employees. It was authorized by Congress without introducing social investment objectives, and it has operated free of any effort by politicians to influence the board's exercise of its fiduciary duties.

Why cannot we offer our constituents the same type of proven apolitical system that every Member of Congress and every Federal employee has in place for their retirement needs?

Our Nation's experience with the successful establishment of an independent board overseeing the investment of Federal employee pensions has provided a blueprint for how to succeed. Robert Reischauer and Henry Aaron have refined this model to meet the needs of the Social Security system. The President has called on us to move ahead. And the bill that Mr. Bartlett and Mr. Pomeroy and I have worked on reflects this work by establishing an independent board empowered to oversee the investment of a portion of the Social Security trust fund in a passive, common stock index fund like the Russell 2000 or Wilshire 5000, overseen by qualified external money managers and operated solely for the economic benefit of the fund. That will assure that every public company is covered from smokestack to high tech.

Mr. Chairman, it seems to me that anyone who really believes that higher payroll taxes or lower benefits will be necessary to ensure solvency, Republican or Democrat, liberal or conservative, faces a critical threshold question. How can you ask workers to shoulder still more burdens involving higher payroll taxes or lower benefits if any of those burdens could be avoided by implementing this type of modest, common-sense investment strategy? At least we should be able to agree on this important first step.

Mr. Chairman, I congratulate you on this important hearing. I do not think you can actually have a debate on Social Security reform unless we resolve these issues first. I congratulate you and I thank you.

Mr. OXLEY. Ladies and gentlemen, we will not be entertaining opening statements from the Chair or the members at this time. We went out of order for our senior member from Massachusetts.

[Additional statements submitted for the record follows:]

PREPARED STATEMENT OF HON. PAUL E. GILLMOR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Now that the proposal is out there of using the equity markets in one form or another to help finance Social Security, we need to carefully examine the proper roles of the public and private sectors. What does the government do better than the private sector? What do the equity markets do better than the government?

Regarding the return on Social Security funds, it is clear that the private markets, over time, offer superior returns. In as much as the equity markets provide better returns, politicians have a natural interest in exploring this option. That's because each dollar of increased return the stock markets can provide for the Social Security trust funds, is one dollar less the government needs to raise taxes or reduce benefits.

But while the markets may provide a better return over time, I also think the government is in better position to provide a "social insurance" guarantee. How do we find the right balance between giving individuals more responsibility for managing their retirement security and ensuring that the social insurance safety net is firmly secured underneath them?

Recently, one 48 year old worker from Northwest Ohio called my office and stated that he would be willing to give up everything he has paid into Social Security in exchange for being allowed to invest his share of his payroll taxes. This individual knows that, as a pay-as-you-go program, the money that he has put into Social Security isn't actually being held for him when he retires. And that is why he is willing to give up everything he has paid in return for the opportunity to know that he has his own individual account. There is a certain sense of security derived from owning a personal account established from your own paycheck.

Besides the concerns about federal ownership of corporate America, this is one reason why I think if we move at least some of the Social Security dollars into the private markets, American workers, not the federal government, should privately own such accounts.

If the purpose of Social Security is to insure against widespread dependency among the senior citizen population, we need to ask ourselves how so many senior citizens have come to depend on the program for their entire financial needs. While finding a better return on Social Security may boost beneficiary checks a little bit in the short term, this fails to solve the underlying question: How can we get workers to save and invest more for themselves? I know our distinguished panels will provide their expertise and insight into these questions.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF HON. JOHN SHADEGG, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Today in my home state of Arizona, President Clinton will promote his proposal to save Social Security. The President has proposed using $2.8 trillion of the $4.5 trillion projected budget surplus over the next 15 years to shore up Social Security. Twenty-one percent of that $2.8 trillion—or *$588 billion*—will be directly invested in the stock market by the federal government under the President's plan.

For several years now, a great deal of attention has been given to the anticipated decline of the Social Security system and proposals to save the system. As we all know, an aging U.S. population combined with a shrinking workforce will result in increased benefits to retirees but fewer tax receipts for the Social Security account. Experts estimate that as early as 2013, just as the baby boomers begin to retire, Social Security will become dependent upon other federal receipts, including the interest currently paid to the trust funds. And as early as 2026, Social Security will be insolvent.

There are, essentially, three options for saving Social Security: increase taxes, decrease benefits, or increase the rate of return of Social Security funds. Considering that I am a strong advocate of reducing the tax burden on the American people, I could not, and will not, support any proposal to save Social Security that would result in a tax increase. Furthermore, I am not inclined to support lowering Social Security benefits to today's retirees, and those who will retire in future years. I don't imagine either group would support it as well. This leaves us with the option of increasing the rate of return on Social Security funds. At this hearing, I hope to find answers to some important questions regarding investing in the stock market to increase the rate of return. Specifically, should we allow the use of personal retirement accounts or should investment be determined by the creation of an independent investment board?

I strongly believe in the tenets of individual liberty and individual responsibility. I have long supported legislation that reduces the size and scope of the federal government and returns power to the American people. For these reasons, I am inclined to support the use of personal retirement accounts to invest in the stock market and to provide for America's retirees in the future. Several pieces of legislation proposed during the 105th Congress, including H.R. 2782, introduced by a witness for the first panel, my friend Mr. Sanford from South Carolina, and H.R. 4824 spearheaded by my colleague from Arizona, Mr. Kolbe, would have diverted a percentage of the Social Security tax imposed on workers into new personal retirement accounts. I am confidant that today's discussion will spark a renewed interest in a Social Security proposal that includes the use of personal retirement accounts.

Prior to joining the House of Representatives in the 104th Congress, I was an attorney both in private practice and as a Special Assistant State Attorney General. I believe very strongly in the ethical standards and practices to which all attorneys must adhere. In the same way, pension fund managers have a fiduciary responsibility to investors. Simply put, they must provide for as high a rate of return as possible with an appropriate level of risk to satisfy future liabilities. This fiduciary responsibility is intended to insure responsible management of investors' money to the greatest extent possible.

However, I am uncertain of this fiduciary responsibility because of political pressures that could arise from government investment in the stock market. Although proponents of the President's Social Security plan are confident that an independent investment board could be insulated from political pressures, I have serious doubts about the government's ability to maintain objectivity when investing in companies that are not politically appealing, such as the tobacco companies. Furthermore, I am deeply concerned about government ownership of private corporations not only because this would be a dangerous step away from our capitalist economy, but also because of the potential and likely negative impact on the market itself.

Finally, current state and local pension funds have been cited as models for the President's proposal. I would simply point out one significant distinction between these pension programs and the system that would be established under the President's proposal: these state pension funds provide retirement benefits *only* to state government employees and not to the residents of the entire state. However, the President's proposal would include *every single American*.

I am very anxious to hear the witnesses' thoughts on the President's proposal and the potential market impact of the federal government investing in the capital markets, including your thoughts on investor protections and corporate governance in those markets. I believe we can all agree that many unanswered questions remain regarding the President's proposal, such as:

- Will the federal government have the ability to purchase a large percentage of shares of one company?
- What is the appropriate ceiling on the percentage of outstanding shares of one company that the federal government would be allowed to purchase?
- Will investing be limited to blue chip stocks?
- Will investing include not only equities, but bonds or derivative instruments as well?
- What would be the rules of carrying cash?
- Who would be appointed to an independent investment board and what qualifications would be necessary for an appointment?
- If a private investment firm would be used to manage the fund and what, if any, guidelines would be put forth by the independent board to regulate the purchase of stock?

I look forward to discussing these points and yield back the balance of my time.

PREPARED STATEMENT OF HON. EDOLPHUS TOWNS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

I commend Chairman Oxley for holding this important hearing. Preserving Social Security is the number one domestic priority of the President and the Democratic Party. I am heartened that there is bipartisan support for that goal.

For almost 60 years, Social Security has protected the economic security of America's retirees, disabled individuals, and children of deceased workers. The Federal Old-Age and Survivors Insurance fund is the most popular economic and social program in U.S. history because of its success in eliminating widespread poverty among the elderly. Whatever reforms are adopted must not undermine that safety net for our senior citizens.

As you know, I represent the 10th Congressional District in New York. New York is the home of Wall Street, the New York Stock Exchange, the world's premier stock market, and most of this country's major investment banks, broker-dealers, and money managers. The Securities Industry Association has testified in favor of Social Security privatization. So I am pleased that this subcommittee is holding this hearing and beginning the process of examining the issues raised by the President's plan. In his State of the Union Address, the President proposed that 62 percent of the unified budget surpluses over the next 15 years be transferred to the Social Security Trust Fund, in order to increase the ability of that fund to meet promised Social Security benefit obligations. The President further proposed that about a fifth of the transferred surpluses be invested in equities to achieve higher returns for Social Security, helping to extend the life of the Social Security trust fund to 2055. This action does, however, raise understandable concerns about the possible extension of political influence on investment decisions and the risks that this might pose to the economy and the Trust Fund. Any system of collective investment can and must address these concerns.

I am taking no position on the President's plan at this time. It would be helpful to have a concrete legislative proposal on the table. In any event, I look forward to hearing from Deputy Treasury Secretary Lawrence Summers and Federal Reserve Board Chairman Greenspan next week on specifics.

Whatever the outcome of this debate, experts agree that investing in the stock market, while helpful, is no panacea for what ails Social Security. In that regard, Mr. Chairman, I am hopeful that we will begin a dialogue with the Ways and Means Subcommittee on Social Security earlier rather than later in this process. An effective solution is going to require us to work together and draw on our combined expertise.

PREPARED STATEMENT OF HON. LOIS CAPPS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Thank you, Mr. Chairman, for holding this important hearing.

Social Security is a critical lifeline for millions of senior and ensuring its long term viability must be one of our highest priorities. That is why I was so pleased when the President's budget continued the call for saving Social Security first, and that on both sides of the aisle this call was well received.

As you know, there are many different reform plans floating around. But one thing they all have in common is that they all seek to increase the return on Social Security dollars by looking to the private markets. The President's plan would invest a small portion of the Trust Fund in equities and establish outside Social Security Universal Savings Accounts that citizens would control. Other plans have called for establishing private accounts within Social Security, that would supplant part of their Social Security benefit and that would manage themselves. Still other plans call for the privatization of the program entirely.

While I am still studying the various approaches to Social Security reform, I have come to some basic conclusions. First, the public safety net approach that Social Security embodies must be retained. The current structure of the program—with its provisions for spouses, the disabled, and survivors—is a critically important program for millions of Americans. For example, Social Security is disproportionately important to women, who live longer than men, are paid less than men, and leave the workforce an average of 11.5 years to raise and care for their families and consequently have lower savings and pensions to rely on as seniors. These major demographic differences between men and women must be taken into account when considering any changes to Social Security.

And second, the issues this hearing is about must be fully explored in order for us to make a fully informed decision. For example, the President's plan calls for competitively chosen private sector managers to handle equity investments for the government to avoid any political interference in the markets. What mechanisms would be in place to keep Congress from passing a law instructing the managers to avoid investment in companies that do business in China, lay off American workers, or whose CEO's donate to one political party or the other? What are the possible effects of the government controlling 4-5% of the equity markets?

Private account plans call for all Americans to make their own investment decisions regarding their accounts. This option also brings a host of questions, many still unanswered. What would those investment choices be? Would they be limited to the types of investment options in the Federal Thrift Savings program? How much of the returns would management fees eat up? Could small businesses afford the added expensive that would come with setting up the individual accounts for every single employee? If not, who would pay? What happens to citizens whose retirement years come in the middle of a long lasting bear market that has substantially diminished the value of their private account?

Simply put, Mr. Chairman, I believe there remains a number of questions regarding all facets of tapping into the equity markets returns. I look forward to a vigorous debate in the coming weeks and months on all these important topics.

Mr. OXLEY. Let me now turn to our distinguished panel: our friend Nick Smith from Michigan, as well as our good friend from North Dakota, Earl Pomeroy. And let me begin with Nick Smith.

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

Mr. SMITH. Mr. Chairman, Mr. Markey, and Mr. Stupak, thank you.

When I came to Congress, I brought two bills with me, so after I was sworn in I introduced two pieces of legislation. One was what was called neutral cost recovery to encourage savings and investment, and the other was a Social Security bill. I have introduced a Social Security bill that has been scored by the Social Security Administration to keep Social Security solvent in each of the last two sessions.

Looking at the President's proposal, I see some strengths and weaknesses. Most important is the decision that the President made to invest some of these funds in the capital markets. The change, I think, is vital because there are only two ways to solve the Social Security problem. You either reduce benefits or you increase revenues coming into the system.

Now, if you cut benefits, I think our preference is to steer away from that. I think the President has wisely concluded that stock market investments would bring in real money and should be part of the solution.

I hear both Republicans and Democrats suggesting that if we just invest part of the surpluses in the capital markets somehow it is going to solve the Social Security problem. Not so. If every penny of the surplus for the next 5 years, both the surplus coming in from the Social Security taxes and the general fund surplus, if every penny of that was invested in the stock market at 10.5 percent, Social Security would still be broke by 2040.

And let me just say that again. If we invest every penny of the surplus that we expect over the next 5 years in the stock market at a 10.5 percent interest rate, it will only keep Social Security solvent until the year 2040. So it is going to take more than just pretending that investing a little bit of that money is going to solve the problem.

First we should all be concerned that government ownership under one of the President's proposals could lead to political tinkering. In the Michigan legislature we had totally removed the decisions of where the State employee pension funds could be invested, but when the highly emotional question of apartheid came along, we changed the law. And, Mr. Markey, we brought it back in and said, well, we are going to decide that we are going to disinvest our pension funds in the State of Michigan from any company that does business with South Africa.

So regardless of the initial law that we passed, if government is going to invest those moneys, there is always the danger of tinkering. Even at the 4 percent government ownership level, government could significantly reduce the value of a particular company's stocks because they are not doing what politicians want on the environment or worker relations or something else.

I think the markets will also think about the implications of government ownership of private companies. It is estimated that the government would own at least 4 percent of all the companies on the stock market within the 5 years under the President's proposal, and this percentage would continue to grow over time.

This ownership creates worrisome potential for government interference. History suggests that this is a real danger.

Finally, markets will question the credibility of the plan, I would suggest. Today the actuaries at the Social Security Administration calculate the shortfall in the program as between $3 trillion and $8 trillion dollars. That depends whether it is a closed system; in other words, are we going to depend on the babies that are not born yet to still help bail out the system. And if it is a closed system and we do not save, we are going to lean on them to help solve the problem in future years, then we approach the $8 trillion to $10 trillion dollar range.

The enormous sum represents a significant challenge. It seems to me that in light of these facts, Members of Congress should ask themselves, what does the President's plan do to narrow this imbalance? Unfortunately the President's plan ducks this problem with complicated accounting gimmicks. The President in the State of the Union address and elsewhere says he is using 62 percent of the surplus to save Social Security. This is certainly misleading.

What the President has actually suggested is adding a new giant IOU to the Social Security trust fund. It becomes an asset to the trust fund, but at the same time it becomes a liability to the rest of the government and the general treasury of the United States. So, in effect, it is a wash. In fact, it is even more than a wash, because I think it is misleading; it puts off the tough decisions of how we are going to save this program, and I think it is important that we do not talk about saving Social Security without also talking about how we are going to save Medicare.

I mean, we could increase Social Security, but if we substantially cut Medicare, then that senior retiree or those disabled or those widows are still just as bad off.

In conclusion, the financial markets, which are run by people who earn their living judging financial risk, will not be fooled by an accounting dodge such as has been proposed. Thus, it is hard to imagine that we will see the positive economic effects that the President has claimed for his proposal.

Congress should not dwell too long on the faults in the President's proposal. He has brought us forward in this debate, and I compliment him for it. If we simply demagogue and criticize, we will lose the opportunity to develop and present a better plan to the American people.

As chairman of the Budget Committee Task Force on Social Security, I hope to work with the President and Democrats and Republicans over the next year to reach a compromise bill to achieve permanent solvency for Social Security. If all sides will enter into the negotiations in a spirit of bipartisanship and good will, I am confident that we can ensure that Social Security will benefit many generations of Americans to come.

I look forward to any of your questions, having introduced the two bills that have been scored to keep Social Security solvent over the past 5 years. It is a challenge. It is a complicated issue as you look at the trust funds that are increasing by three different aspects. One is the actual cash tax revenues coming into the fund; the second is the interest earned on those non-negotiable bonds; and the third, of course, is the Social Security taxes that would otherwise be paid by Federal employees.

Mr. Chairman, thank you.

[The prepared statement of Hon. Nick Smith follows:]

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

In this year's State of the Union address, the President unveiled his long awaited plan to protect and strengthen Social Security. While I have strong reservations about aspects of the President's proposal, it must be recognized that the President has moved the Social Security debate forward and offered a starting point for serious reform. As a long time advocate of Social Security reform, I think that we should commend the President for putting a proposal forward over the opposition of some in his party and emphasize the positive aspects of his plan.

Looking at what the President has proposed, I see some strengths and some weaknesses. The most important decision that he has made is to use the capital markets to increase the rate of return on Social Security assets. In doing so, he has decided to break with some in his party. This change is vital because there are only two ways to address the long-term imbalance in the Social Security system: cut benefits or increase the revenues coming into the system. The President has wisely concluded that stock market investments—which would bring in real money—should be part of the solution. It should be noted that even if every penny of the budget surplus over the next five years was invested in the capital markets at a nominal return of 10.5%, Social Security would still be broke in 2040.

To the degree that the President's plan can lead us to a solution based on savings and real investment rather that the current system of income redistribution, the markets should rejoice. But, and this is important, the markets have to be wary of other aspects of the plan which could presage a large and dangerous expansion of government control in private markets, and a corresponding diminution of the market influences which ensure the efficiency of the financial markets.

First, we should all be concerned about government ownership and control of stock market investments. With government ownership, there is no guarantee that workers will see the benefits from higher returns. The government might spend those earnings on other government programs as it has spent the Social Security Trust Fund. In my opinion, there is no point in requiring workers to assume the limited but real risk of market investment without some guarantee that they will share in the gains as well. Because the Supreme Court has ruled that workers have no ownership rights in the current Social Security program, regardless of taxes paid in, worker ownership is the only way to ensure that gains from the market actually accrue to workers.

The markets, however, will also think about the implications of government ownership of private companies. It is estimated that the government would own at least 4% of all the companies on the stock market within five years under the President's proposal, and that this percentage would continue to grow over time. This ownership creates worrisome potential for government interference to reward and penalize private companies for political reasons.

History suggests that this danger is real. A number of states have come under pressure to direct pension investments away from companies that produce products that some people object to or that do business in disfavored countries. Both the enormous size of the trust fund and the centrality of Social Security in our politics will intensify these pressures. Indeed, the Rev. Jesse Jackson recently testified that he would organize opposition to investments in liquor, gun and tobacco producers if the President's plan was adopted. We have to recognize that the government will inevitably fall under pressure to use resources that it holds in the trust fund to achieve political ends.

Finally, markets will question the credibility of the plan. Today, the actuaries at the Social Security Administration calculate that the shortfall in the program is between $3 trillion and $8 trillion. This enormous sum represents the difference between what the government has promised to American workers and what it is prepared to pay under current law. It is also worth noting that this shortfall is calculated under the optimistic assumption that the government will repay the Social Security Trust Fund in full and with interest. Thus, we really need to add the Trust Fund balance to this estimate to get a true accounting of the problem.

In light of these facts, members of Congress should ask themselves, "What does the President's plan do to narrow this imbalance?" Unfortunately, the President's plan ducks this problem with complicated accounting gimmicks. The President, in the State of the Union address and elsewhere, says he is using 62% of the surplus to save Social Security. This is certainly misleading.

What the President has actually suggested is that another giant IOU representing 62% of the surplus should be put into the Social Security Trust Fund along with all of the other IOUs. To the public, the new IOU conveys the impression that the Trust Fund will have additional assets to back future benefits. It does not, however, increase the government's financial capacity to *pay* benefits at any point in the future. In short, it increases the assets of the trust fund by the same amount that it increases the liability of the general fund. In other words, it's a promise we have no ability to keep.

The financial markets, which are run by people who earn their living judging financial risk, will not be fooled by this accounting dodge. Thus, it is hard to imagine that we'll see the positive economic effects that the President has claimed for his proposal.

Congress, however, should not dwell too long on the faults in the President's proposal. If we do so, we will lose the opportunity to develop and present a better one to the American people. As Chairman of the Budget Committee Task Force on Social Security, I hope to work with the President and Democrats over the next year to reach a compromise bill to achieve permanent solvency for Social Security. If all sides will enter the negotiations in a spirit of bipartisanship and good will, I'm confident that we can ensure that Social Security will benefit many generations of Americans to come.

Mr. OXLEY. Thank you, Mr. Smith.

We now turn to our friend from North Dakota, Mr. Pomeroy.

STATEMENT OF HON. EARL POMEROY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. POMEROY. Thank you, Mr. Chairman. I appreciate very much you holding this important hearing. I am also pleased to participate with my colleagues. I have had over the years many discussions with them. We have quite different notions in terms of how Social Security should be protected and enhanced, but I know that they are very sincere and have given this a lot of time and effort over the years.

As we all know, the reason we are discussing investment of the trust fund is to address the Social Security shortfall. To close this long-term financing gap, we basically have three policy choices: Increase taxes; cut benefits; or increase investment return.

Now, investing a modest share of Social Security reserves in equities strengthens the program's financial position and reduces the magnitude of benefit reductions or tax increases that would otherwise be required.

The President has proposed a plan that requires transfers to be made from the U.S. Treasury to the Social Security trust fund each year for 15 years. Of the amount transferred, $2.8 trillion in total, a portion would be invested in the private sector on a phased-in basis from 2000 through 2014, producing an ultimate investment position of 14.6 percent of the trust funds in equity indexes.

The remaining 85.4 percent would continue to be held in government securities. This allows the trust fund to achieve a higher rate of return without assuming undue risk.

Now, no one is pretending that this is the silver bullet to fix the shortfall in Social Security. It is a part of the answer and an important part of the answer.

Investment of the trust fund in equities brings Social Security in line with the best practice of both private and public sector pension plans. An overwhelming number of private and public pension plans involve equity investment as part of their strategy to maximize an optimal investment return.

Among large private-sector defined benefit plans, more than 40 percent of the total assets are in equities. Contrast that with the not quite 15 percent proposed by the President.

State and local pension plans invest $1.3 trillion in the market today. No one is suggesting we socialize corporate America through that investment position, even though it represents 10 percent of the entire valuation of the stock market.

I previously served on an investment board. I have done the socialist undertaking of investing State tax dollars in private stocks as a member of the State investment board. We did not social engineer. We served what the law required, the exclusive benefit of North Dakota employees and existing retirees as required, again, under Federal law.

Federal funds are also privately invested. The pension reserves of the Tennessee Valley Authority and the Federal Reserve System as well as participants of the Federal Thrift Savings Plan, TSP, are now invested in common stocks.

I want to note the Federal Reserve Board's own pension program has a 65 percent equity position with their own asset allocation.

But despite these successes, questions have legitimately been raised about whether it is possible to invest a small portion without risking political interference in private business decisions.

I believe that President Clinton's proposal gives sufficient safeguards and agree with Treasury Secretary Robert Rubin's observations that there are really two layers of protection against political interference. Those two layers he identified consist of an independent oversight board and a selection of private fund managers. The first layer, this independent board, members of which would be top-flight financial experts, would be established to select and oversee private fund managers. That is all. Board members would be appointed for lengthy staggered terms, and neither the President nor Congress would be able to remove them.

The second layer is private fund managers selected by competitive bidding and charged with investing a small portion of the Social Security reserves in broad market index funds. Secretary Rubin has emphasized, and I quote, "the government will be involved absolutely not at all in the investment." And to that end the structure we are proposing is triply insulated beyond what a State pension fund would be, including the one that I served on.

In reality, there is a third restriction on political interference similar to the Thrift Savings Plan. It is likely that these indexes would also contain index funds from a number of private parties further guaranteeing the strictest fiduciary standards in the investment of these funds.

In conclusion, I think that this proposal, the President's trust fund investment proposal, is best understood as a proposal to professionalize the management of Social Security reserves, diversifying the trust fund's investment so American workers can get a better return, and moving the money in management reserves not held in Treasury bonds outside of the political realm and beyond the reach of elected officials.

In my view, if it is politically taboo for Congress to intervene in workings like the Federal Reserve Board, believe me, it will be even more taboo for Congress to interfere with the professional management of Social Security pension reserves of nearly 150 million workers and retirees.

I am pleased to join Congressman Markey in proposing a framework for consideration with bill introduction today, cosponsored by Congressman Bartlett. I think that this question of political interference is an important one, and we can design the structure that will prohibit it. This bill takes a first crack at putting into place the safeguards. And I invite all of you not just to say no, no, never, never, but work with us on making certain we have a design structure that provides the safeguards we all want.

Thank you.

[The prepared statement of Hon. Earl Pomeroy follows:]

PREPARED STATEMENT OF HON. EARL POMEROY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. Chairman and Members of the Subcommittee:

Thank you for holding this important hearing to evaluate the issue of investing a portion of the Social Security trust fund in the stock market. As we are all aware, the reason investment of the trust fund is under consideration is to address the Social Security shortfall. It is estimated that the Social Security trust fund will run out of money by the year 2032, resulting in benefits being funded exclusively from FICA tax collections at that time and potentially resulting in benefit reductions of 25 percent.

To close this long-term financing gap that Social Security currently confronts and place it on a sound financial footing for future generations, we have three basic policy choices—increase taxes, cut benefits, or increase investment returns. Investing a modest share of Social Security reserves in equities would strengthen the program's financial position to the benefit of future generations and reduce the magnitude of the Social Security benefit reductions that would otherwise be needed.

In his State of the Union address, President Clinton proposed a plan that would require that transfers be made from the U.S. Treasury to the Social Security trust fund each year for 15 years. The amount transferred each year would be specified in law, so that by 2015, about $2.8 trillion would have been transferred. A portion of these funds would be invested in the private sector each year, from 2000 through 2014, until such time as 14.6 percent of the trust funds are in private investments. The remainder, 85.4 percent, would continue to be held in government securities. This allows the trust fund to achieve a higher rate of return without assuming undue risk.

This investment of the trust fund in equities would bring Social Security into line with the best practice of both private and public sector pension plans. An overwhelming number of private-sector defined-benefit pension plans invest part of their reserves in equities. Among large private-sector defined benefit plans more than 40 percent of total assets are invested in equities.

Similarly, pension reserves of the Tennessee Valley Authority and the Federal Reserve system, as well as assets of participants of the Federal Thrift Savings Plan (TSP) are now invested in common stocks. The Federal Reserve's pension plan for instance, has 65 percent of the portfolio backing their defined-benefit pension plan invested in equities.

Despite these successes, there is some question as to whether it is possible to invest a small part of the Social Security reserves in common stocks—as the President has proposed—without risking political interference in private business decisions.

I believe that President Clinton's proposal gives more than adequate safeguards and agree with Treasury Secretary Robert Rubin's observation that, "there are really two layers of protection against political interference." Those two layers he identified consist of an independent oversight board, and the selection of private fund managers.

The independent board, the members of which would be top flight financial experts, would be established to select and oversee private fund managers. Board members would be appointed for lengthy staggered terms, and neither the President nor Congress would be able to remove them. The private fund managers would be selected through competitive bidding and would be charged with investing a small portion of the Social Security reserves in broad market index funds. Secretary Rubin has emphasized, "the government will be involved absolutely not at all in the investment."

In reality there is a third restriction on political interference created by the fact that all funds would be passively invested in very large index funds. Similar to the Thrift Savings Plan it is likely these indexes would also contain investment funds from a number of private parties, further guaranteeing the strictest fiduciary standards in the investment of those funds.

The President's model mirrors the existing structure of the Federal Reserve Board and the Federal Retirement Thrift Investment Board.

With this structure, the Fed has successfully maintained its independence for decades in setting monetary policy; it, not Congress or the executive branch, establishes those policies.

The Federal Retirement Thrift Investment Board has similarly maintained its independence and not been subject to political meddling since its creation in 1986. As Francis X. Cavanaugh, the board's first executive director, has noted, Congress designed the board to be insulated from both political interference and corporate decision-making, and this design has worked. The TSP investment board, and Mr. Cavanaugh made clear from the beginning that economic, not social or political, goals were to be the sole purpose of the investment board. The TSP has perpetuated this norm by refusing to yield to pressure to invest in economically targeted investments or to divest stocks of particular companies.

In some ways, the President's proposal is best understood as a proposal to professionalize the management of Social Security reserves, diversifying the trust fund's investments so American workers can get better return, while moving the reserves not held in Treasury bonds outside the political realm and beyond the reach of elected officials.

In my view, if it is politically taboo for Congress to intrude upon the workings and decisions of the Fed, it would likely be even more taboo for Congress to interfere with the professional management of the Social Security pension reserves of nearly 150 million workers and retirees.

As Henry Aaron and Robert Reischauer recently observed, "no public policy can meet the standard of zero possible abuse. If such a standard applied to all decisions, we would not have a standing army for fear some rogue general might run amok, or a Federal Reserve because some Congress might interfere with its independence. In each case, Congress acted because the benefits were clear and safeguards minimized risks."

Some contend the better way to pursue higher investment returns within Social Security is to create individual accounts for each person covered under the program, and allow private investment on an individual basis.

On closer evaluation, however, this alternative is not as desirable as may first be assumed.

Inevitably, risk and uncertainty would be substituted for the guaranteed nature of Social Security benefits.

In addition, there are very substantial administrative costs that attach to a plan offering private investment opportunities to individuals within the Social Security plan. Estimates are as high as 30 to 40 percent, counting annuitization costs. Obviously, net investment gains could be completely wiped out by the expense of purely private investment accounts within Social Security.

As a result, most proposals establishing private accounts use the Thrift Savings Plan as a model, which could reduce administrative expenses to eight percent. This is still substantially higher than the nominal cost of the trust fund investment approach.

The result of pursuing individual accounts similar to those of the Thrift Savings Plan ultimately produces the need for a government board charged with selecting private money managers to invest the pooled individual accounts. This is virtually identical to the framework required for trust fund investing.

In summary, investing 15 percent of the Social Security trust fund in equity index accounts makes an important contribution to addressing the financial shortfall in Social Security without sacrificing the guarantees of Social Security or relying completely on raising taxes or reducing benefits to beneficiaries. The President's proposal professionalizes the management of this portion of the trust fund and removes it from the political realm for the exclusive benefit of American families covered by this program.

Mr. Chairman, this concludes my remarks. I would be happy to take questions from the Subcommittee.

Mr. OXLEY. Thank you.

Our third panelist is the distinguished gentleman from South Carolina, Mr. Sanford.

STATEMENT OF HON. MARK SANFORD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH CAROLINA

Mr. SANFORD. Thank you, Mr. Chairman, and thank you, members of the subcommittee for allowing me the chance to talk about the market impact of the President's proposal on Social Security.

The ultimate answer is: I do not know. In other words, I think given the complexity of the capital markets, you cannot say based on one very little business what the capital markets will do, but what I can say is that there are certain probabilities based on how capital markets react to what the President has proposed. And to look at those, I think you would simply look at what is it that he proposes.

He proposes three things: one, precommitting dollars to government in a way, frankly, that has never been done before; two, investing part of the trust fund in equities as was already mentioned; and, three, introducing USA accounts which would be supplemental savings accounts.

On the first point, precommitting dollars to government in a way that has never been done before, this is very significant, because they do this by precommitting $2.8 trillion of anticipated general fund surpluses over to the Social Security trust funds.

Now, leaving aside the fact that this may never happen—I do not know if you all saw the Economist article 2 weeks ago entitled "Counting Your Chickens Before They Hatch," which was all about maybe these surpluses come, maybe they do not. But let's just assume the surpluses came. What is dangerous about this is that prefunding precludes the private allocation of capital.

Let me say that again. Prefunding, precommitting, precludes the private allocation of this $2.8 trillion of capital.

Now, that is very significant, because almost any economist you talk to would say that ultimately the private markets, the capital markets, are better at allocating capital within our economy than government. Not to say that one is bad and one is good, but just better in this sense: if you were to take two hypothetical chain saw factories and one was to be made by the capital market, the capital markets would decide on that chain saw factory based on return on equity. government, if we were making the decision because we make politically base decisions, we would decide in part is it in my district, is it in my country, does it have a certain type of labor force, a lot of other considerations which are important to us in politics. But it makes for two very different sets of investment choices and a very different allocation. And that is on the good one, that is if it was an investment.

If it was in something less than an investment, for instance, a social welfare system that possibly did not work, that was structurally flawed, or let's say a road to nowhere, but it did happen to have a Senator or Congressman's name on it, I mean all those to are possibilities within government.

So I would say at the onset that this proposal, because it precommits $2.8 trillion of anticipated general fund surplus to government, means that there will be poorer asset allocation of that money, and consequently a drag on GDP which affects markets.

The second point would be it precommits—in other words, since we are now within the government section, it precommits to consumption rather than investment. And I think that my friend from Massachusetts would be the first to say that, for instance, there are certain very good uses of government capital, for instance, an investment in human capital; in other words, investment in education.

Well, that is not what this would do. This precommits that $2.8 trillion not to education, but to consumption. And we have to ask: Would that be a good or a bad investment? It would be, from a macroeconomic standpoint, a relatively poor investment choice, because savings drives investment which drives productivity which ultimately affects standard of living, and consequently growth of GDP, and growth in GDP is a direct tie back to market. So we would also have a drag on markets from the standpoint it is an infusion for consumption rather than investment.

The third point would be it precommits a tax increase. And I would say that, because if you look at the—if you look at page 30 at the analyst perspectives of the President's budget, what you would see there is under discretionary spending, which in 1995, 7.6 percent of GDP, it pulls down to 3 percent of GDP. So that is saying one of two things. That is saying—it is saying basically since baby boomers to come, there are 70 million of them, and since, you know, we have got this large flow there, therefore to keep the numbers within any kind of sustainable range—historically we have been at or around 20 percent of GDP, government expenditure, keep that going to 30 percent, we just have to waive domestic discretionary. How realistic do you think it is that we will have domestic discretionary? I think we would probably agree that that is probably unrealistic, and then given the political clout of the baby-boom generation, again, 70 million strong, is it realistic to think we would cut benefits or raise taxes? I think it is more likely that we raise taxes.

Finally, it leaves uncertainty and markets do not like uncertainty. Come 2056, there is nothing better in terms of the prospects for a retiree at that point than exist today. In other words, there is still a cloudy horizon and markets do not like uncertainty. It has already been tested in terms of trust fund. Investment equity, I think Alan Greenspan can well address that issue.

And the final component, which are USA accounts, accounts, Australia interestingly addressed that issue, and it was a labor movement and a labor government that ultimately said, voluntary accounts do not work because they turned out to be very regressive. People at the lower end of the socioeconomic scale did not have the money or the credit, and consequently could not exercise it. It was the labor movement and labor government that pushed for mandatory accounts.

Thank you very much.

[The prepared statement of Hon. Mark Sanford follows:]

PREPARED STATEMENT OF HON. MARK SANFORD, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF SOUTH CAROLINA

Thank you Mr. Chairman and members of the subcommittee for allowing me the opportunity to talk about the market impacts of President Clinton's Social Security proposal.

The ultimate answer is, I can't say for certain what the market impacts will be. Given the complexity of the capital markets, it is difficult to say based on one variable that, "this is what the capital markets will do." What I can say is that there are distinct probabilities how the capital markets would react to what the President has proposed.

The President's proposal includes three components: 1) Pre-committing dollars to government in a way that has never been done before, 2) investing part of the trust fund in equities, and 3) introducing USA accounts, or supplemental savings accounts.

On the first point, pre-committing dollars to government in a way that has never been done before is very significant. The Administration's proposal pre-commits $2.8 trillion of anticipated general-fund surpluses over to the Social Security Trust Fund, in essence shifting debt held by the public to debt held in the form of IOUs by the trust fund.

I don't know if you saw the Economist article that came out about two weeks ago entitled "*Counting Their Chickens Before They Hatch*," which spelled out the case for why it is dangerous to rely on surpluses before they materialize. Let's leave that aside for the moment and assume these surpluses materialize.

While I agree with the President on the worthiness of reducing the public debt, it does nothing to shore up Social Security. The President's plan commits 62% of the unified surplus to reduce the debt held by the public. The Administration's plan simply shifts debt from being held by the public to being held by the Social Security trust fund. The net effect on the national debt, which counts both public and intragovernmental debt, is zero.

There is no question that, in the short term, the President's plan to reduce the public debt will lower interest rates as the federal government would no longer be bidding up the cost of borrowing money. Over the long term, the implications of such a plan are uncertain at best.

The President's plan pre-commits us to a tax increase. After 2013 when we start cashing in the bonds in the trust fund to pay benefits, if the money isn't in the budget, Congress would have just two familiar options: 1) raise taxes or 2) cut benefits.

The President's projections utilize a tactic that has never worked: his plan assumes that domestic discretionary spending will be cut more than half. I say that because, if you look at page 30 of the analytical perspectives of the President's budget, you would see that his assumptions are that domestic discretionary spending, which in 1995 was 7.6 percent of GDP, pulls down to 3 percent of GDP in future years. Folks in Congress, on both sides of the aisle, want to bust the prudent budget caps set not even two short years ago. The current debates over extremely modest trims of spending caps should make it crystal clear that future Congresses and Presidents will definitely not cut domestic discretionary spending by more than half.

What does that leave us with? How realistic do you think it is that we will cut domestic discretionary spending in half? Given the political clout of the baby boom generation at 70 million strong, isn't it more realistic to think we would cut benefits, raise taxes, or borrow more money? I think it's likely that we'd raise taxes.

The President's proposal leaves uncertainty and markets don't like uncertainty.

As for the President's proposal to have the federal government invest $700 billion of the trust fund in private equities, I think most serious independent experts side with Fed chairman Alan Greenspan's assessment that this is a misguided idea. No matter how many firewalls we might attempt to erect, no matter how independent we try to make the investing body, politics would inevitably infect the process.

Just look at the nature of government compared to private markets. Let's take two hypothetical chain saw factories—one operated by the capital markets which would make decisions based on return on equity, and the other operated by the government. The government makes decisions, unfortunately, based largely on politics. Government officials ask questions like "is that factory in my district, is it in my country, does it have a certain type of labor force" when they make decisions. This makes for two different sets of investment choices and a very different allocation.

I would say that the President's proposal to have the government invest a portion of the trust fund will cause poorer asset allocation of that money and consequently a drag on GDP.

As Greenspan noted, government investing does not necessarily increase national savings—it would more likely simply displace other capital. Personal accounts with savings, however, would increase national saving. From a macro-economic standpoint, it would be a relatively poor investment choice to pick government over private individuals. Savings drive investment, which drives productivity gain, which ultimately affects standard of living, and consequently grows the GDP. Growth in GDP is a direct tie back to markets.

As for the third component of the President's plan, Universal Savings Accounts, it falls short of the mark. Australia interestingly addressed this issue. It was a labor movement and a labor government which ultimately said voluntary supplemental accounts don't work because they would turn out to be very regressive. People at the lower end of the socio-economic scale didn't have the money for the credit and consequently couldn't exercise it. It was the labor movement that pushed for personal accounts funded by diverting payroll taxes into the accounts.

The real solution is to personalize Social Security by allowing people to divert a small portion, say 2-3%, of their FICA taxes into an account with appropriate safeguards and limited investment options. Social Security taxes are taxes on first-dollar earnings, so every working American pays them—which is the best qualification for a way to fund personal accounts. Under this system, no working American would be turned away for a lack of money. At the same time, we would chip away at the unfunded liability of the program and grant people a great opportunity to build and create wealth.

If we reject personal retirement accounts in favor of pre-committing money to the paper ledger of the Social Security trust fund, then we would preclude the private allocation of capital. Let me say that again—pre-committing precludes the private allocation of this $2.8 trillion of capital through personal accounts. That is significant because just about every economist says that ultimately, the private markets are better at allocating capital within our economy than government. Not to say that one is bad and one is good—the private markets are just better in this sense.

Thank you Mr. Chairman.

Mr. OXLEY. Thank you to our panel, and because we had a late start today, we are going to waive questions for the panel. We appreciate your participation and staying engaged in this very important issue.

Mr. SANFORD. Mr. Chairman, will our written statements be included in the journal?

Mr. OXLEY. The written statements will be part of the record.

Mr. SANFORD. May I make a short 30-second comment?

Mr. OXLEY. Sure.

Mr. SANFORD. The Supreme Court—the main decision was Fleming v. Nestor—decided that there was no entitlement for Social Security payments; regardless of the taxes or how long you paid into Social Security, there was no right to receive any benefits. And I think it is reasonable to expect that if government controls these funds, they will take the additional revenue from these funds and use them in the same way as they have the Social Security trust funds.

In other words, if we come to crunch on a balanced budget, they will simply spend those funds for other government spending and it will not give any assurance that future retirees will have extra assurance for retirement.

Mr. OXLEY. Thank you, and thank you all.

Let me now return to regular order, and I see our friend from Richmond at the dais. Does the gentleman have an opening statement?

Chairman BLILEY. Mr. Chairman, I thank you for recognizing me. In the interest of time, I will submit it for the record. I applaud you for having this hearing today on this very, very important subject.

[The prepared statement of Hon. Tom Bliley follows:]

PREPARED STATEMENT OF HON. TOM BLILEY, CHAIRMAN, COMMITTEE ON COMMERCE

This is the first hearing of the Finance Subcommittee in the 106th Congress. I think that it is appropriate that this hearing is devoted to an examination of market impact of the President's Social Security proposal.

Solvency of the Social Security system is vitally important. I commend the President for beginning the debate by coming forward with a proposal to deal with the impending problems of Social Security.

A number of estimates by the CBO and the bipartisan task force on Social Security indicated that absent reform, Social Security will begin paying out more than it takes in sometime around 2013. Obviously, the earlier we deal with the structural issues causing this problem, the easier it will be to fix them.

The President has recognized that the Budget Surpluses we have worked so hard to produce in the last Congress and the surplus from current workers now paying into the Social Security system, gives us an opportunity to work to save Social Security and improve the retirement of all Americans.

The President has recognized, as did the members of the Advisory Council on Social Security, that there is a role for investment in the stock market as part of any reform of Social Security. Simply put, the rate of return to investors in the stock market has been about 13% per year over the past forty years. This return is much more attractive than anemic or sometimes negative returns that participants in Social Security receive on their contributions.

If the returns of the market can be extended to all Americans we can substantially improve the lives of Americans as they retire.

I believe that this Committee which has historically looked to promote capital formation will play an important role in protecting investors and insuring that increased market participation by Americans will be safe and fair.

There are four basic principals that I will use to evaluate any Social Security proposal:

First, there can be no diminution of benefits to current retirees. We have made an agreement with millions of Americans, who depend on Social Security and we must keep it.

Second, any changes to the Social Security System that involve private investment should be completely voluntary. If a person doesn't want to participate, he or she should be able to stay in Social Security as it currently exists.

Third, any system of private investment must have appropriate safeguards. We are not going to have Social Security money put in risky derivatives, cattle futures or other speculative instruments.

Fourth, any Social Security reform must increase the rate of return to the participants. I understand that for many young people, the expected return for their lifelong contributions will be negative. For others, less than a paltry 1% per year. People can do better in pass book savings accounts. We should look to find a way for the benefits of the market to be shared, prudentially with all Americans.

This hearing will be the beginning of a long process. I commend the Chairman, Mike Oxley for holding this hearing, and for his superb leadership in the last Congress which included moving the Stock Exchanges to Decimal Pricing, passing Repeal of Glass-Steagall in the House, and enactment of Uniform Securities Litigation Standards.

I welcome the new Ranking Member of the Subcommittee, Mr. Ed Towns from New York. He has been a good friend for many years and I look forward to working with him in his new role. I also commend John Dingell, the Ranking Member of this Committee. Over the years we have solved many problems and this one will be no different.

The Committee will be active in the area of Social Security reform. We will work to improve the retirement of all Americans and see that any private investment is done safely. Next week we will continue this hearing. I am pleased that Federal Reserve Chairman Alan Greenspan has agreed to come and analyze the President's proposal for us. Additionally, we are working with the Treasury to facilitate an appearance by a representative of the Administration.

I welcome the witnesses and yield back the balance of my time.

Mr. OXLEY. Thank you, sir. All opening statements will be made a part of the record. The Chair would, before calling up our second panel, enter his opening statement.

This is the first in a series of hearings that the subcommittee will be holding on what is probably the most important financial issue facing this Congress: how best to ensure a secure retirement for all Americans. The next hearing on this subject will be next Wednesday, March 3, when the Federal Reserve Chairman Alan Greenspan will offer his views on the President's proposal, as well as a representative of the Treasury. We expect Mr. Lawrence Summers will be testifying that day as well.

By now, people have heard the alarming fact that in at least 14 years the Social Security system will be paying out more in benefits than it is receiving in taxes. While it is estimated the interest income that will be paid to the Social Security trust fund will delay depletion of the fund for about 7 more years, the fact is that in a very short time we as policymakers will be given a very limited list of options to choose from to keep the system in the black: raise taxes, cut spending, or borrow the money to make up for the deficit. At that point it is going to be too late to being talking about reform.

That is why it is so important to begin work on reforming Social Security today. We do not want to find ourselves a few years down the road trying to convince the American taxpayers that they really should not mind paying more taxes to bail out the system if the government fails to act in time, or try to convince American retirees they should not expect all the same benefits that they paid for years into the system to provide for their predecessors, or putting off the inevitable by applying a temporary patch to the problem, which is only going to grow worse when more Americans retire and fewer workers are available to support them. We cannot fail the American people by taking such an irresponsible attitude toward their future.

What is heartening to see is that the President has recognized this very problem. He indicated in the State of the Union address that he intends to put saving Social Security among his top priorities.

It is also good to hear the notion that investing in the stock market is a component of a proposal to save Social Security. As we learned the last time there was a hearing before this subcommittee on this subject, the rate of return that today's workers have seen on the taxes they pay into the system is a business despite the over 1 percent for an average household with two 30-year-old working parents who each make under $26,000. For today's youngest workers, the rate of return is expected to be negative. That means they are losing money for every tax dollar they pay. That rate of return would be enough to make an investment by an investor advisor on the spot. We can increase the rate of return. In the example I just mentioned, if the family's tax dollars were invested not in the Social Security system as we know it, but in a conservative private investment like a low-risk mutual fund, the expected rate of return would be over 5 percent per year.

Many experts believe that such a higher rate of return for even just a portion of the Social Security payroll tax would more than offset the anticipated shortfall of the fund. Putting back a sum of money into the stock market, however, would have enormous impact on our capital markets. How that money is invested into the markets, as well as what happens to the markets as a result of this capital infusion, raises numerous questions that we will consider in this and upcoming hearings.

One concern that has been raised by Chairman Greenspan, among others, is the disturbing conflicts of interest that would be created by giving the government direct or indirect control over investment of Social Security dollars in the market, as the President's proposal contemplates.

Mr. Greenspan is implying that government-controlled investment would put at risk the efficiency of our capital markets and our economy. Politically motivated investment decisions by government pension fund managers have often led to losses for investors. Even worse, granting government control over investments in the marketplace would lead to an ominous blurring of what is private and what is government.

Embracing government-controlled investments would suggest that creating private accounts, which investors rather than the government would control, is a better approach to saving Social Security. But creating private accounts would require an American worker who may not have any experience in investing in the markets to make investment decisions that will affect their retirement security.

How can we assure that these new investors have the tools they need to manage those accounts? How can we better protect them against fraud? How can we maximize the benefits for American investors while minimizing risks? These are questions that go to the most fundamental concerns we have: the integrity and success of our capital markets and protection for investors.

We look forward to tackling these issues together with Chairman Bliley, the ranking member John Dingell, and friends on both sides of the aisle in the spirit of bipartisanship.

That concludes the opening statement of the Chair. I recognize the gentleman from Illinois for an opening statement.

Mr. SHIMKUS. Thank you, Mr. Chairman, and I would like to thank you for holding this hearing. I applaud your effort to use this subcommittee to examine the President's proposal to invest a portion of the Social Security trust fund in the stock market. Although the Ways and Means Committee has jurisdiction over Social Security, Rule 10, clause 1(b)15 gives this subcommittee jurisdiction over the stock market. I believe we should vigorously protect our committee's jurisdiction to ensure the compatibility of the President's proposal for the stock market and savings.

I look forward to this hearing because I am very interested in the aging and how it affects Social Security, and how to ensure its existence for my children and your children. Social Security has fundamentally changed the life in America. Before Social Security, elderly Americans had virtually no retirement income unless they were very wealthy. Now all Americans have an investment and an income when they retire.

No one wants to live solely off of Social Security, but the simple fact is that in my district many people do. We also know that we must ensure that Social Security is available for future generations. Under the current system there is no way that Social Security will survive with the retirement of the baby-boomer generation.

However, in our efforts to preserve the trust fund, we should not make hasty, radical changes that increase the risks to the system. We must save Social Security, not destroy it.

I, like the President and many of my colleagues on both sides of the aisle, want to ensure that the Social Security trust fund receives the maximum return on its investment. I believe any discussion of investing the trust fund in the market must be guided by three core principles: first, the investment must limited to a portion of the trust fund. We cannot allow the trust fund beneficiaries to be 100 percent dependent on the stock market. Social Security has been successful, but if all else fails, our elderly citizens need to know that they can count on their income from Social Security. We cannot allow Social Security to evaporate if the market crashes or other adverse events occur.

Second, we must ensure that the government does not become involved in the business decisions of corporations or become a player in the market. The U.S. Government cannot and will not be a productive player in the equities market. Instead, we should establish an oversight board, similar to the Thrift Savings Plan, to ensure the investment decisions of millions of Americans are not made by politicians.

Finally, Mr. Chairman, we should require diverse investment for the trust fund. Spreading the risk over diverse industries as well as different investments will both increase exposure to the fund to make sure the government does not become too powerful in one industry or market.

Mr. Chairman, I have not decided whether or not to entrust the savings of millions of Americans in the stock market is the solution to extending the solvency of the Social Security trust fund and protecting a program that is the life blood of our Nation's elderly. However, I do know that we need to explore this issue. I commend you again for calling this hearing and the March 3rd hearing, and I look forward to many more. Everybody agrees that it will take bipartisan cooperation to save Social Security. I hope this committee can set an example for the entire Congress.

Mr. Chairman, I am going to run off to another hearing. I plan to be back. Thank you again for the opening statement.

Mr. OXLEY. I thank the gentleman.

Any other opening statements on my right?

[No response.]

Mr. OXLEY. Then we will proceed to the second panel: James Glassman, DeWitt-Wallace Reader's Digest Fellow, American Enterprise Institute; Robert Reischauer, Senior Fellow at the Brookings Institution; and David C. John, Senior Policy Analyst for Social Security with the Heritage Foundation.

Gentlemen, we appreciate your patience and your attendance here today and look forward to a discussion about a very important subject which is as near and dear to all of us as is the capital markets and Social Security.

Let me begin, if I may, with Mr. Reischauer, and again, we appreciate all of your testimony.

STATEMENTS OF ROBERT D. REISCHAUER, SENIOR FELLOW, BROOKINGS INSTITUTION; DAVID C. JOHN, SENIOR POLICY ANALYST FOR SOCIAL SECURITY, HERITAGE FOUNDATION; AND JAMES K. GLASSMAN, DEWITT-WALLACE READER'S DIGEST FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. REISCHAUER. Mr. Chairman, members of the committee, I appreciate the opportunity to participate in this hearing. It is, as you have heard from several of the previous witnesses, an unpleasant yet inescapable reality but there are three and only three ways to close Social Security's long-term fiscal deficits: taxes can be raised; benefits can be reduced; or the return on the trust fund's reserves can be increased.

Given this reality, it is important to compare proposals to invest a portion of the Social Security reserves in private securities with the realistic alternatives that are out there. Although there are legitimate concerns with this option, which I will discuss in a minute, there are problems with all of the alternatives as well. There are problems with raising payroll taxes, with increasing the age at which unreduced benefits are paid, increasing the age at which initial benefits can be taken, or reducing the size of the annual cost-of-living adjustment.

There are two good reasons why it makes sense to invest a portion of the trust fund reserves in private securities. First, such a policy will boost the earnings of the reserves and thereby reduce the size of the benefit cuts and payroll tax increases that will be required to deal with Social Security's problems. As other witnesses have said, investing the reserves in higher yielding assets is not a complete solution. It can help but it cannot solve the problem by itself.

Second, easing the restriction that requires Social Security to invest reserves exclusively in government securities would provide workers with a fairer return on their payroll tax contributions, one that is closer to the benefit that their contributions are making to the Nation's economy. To the extent that reserve accumulations add to national savings, they generate total returns to the Nation equal to the average return on private investment, which runs about 6 percent more than the rate of inflation. By paying Social Security a lower return, a return that is projected to average only 2.8 percent over the next 75 years—that is 2.8 percent over and above inflation—the system denies workers a fair return on their contribution.

There are, however, some legitimate concerns that have been raised about investing trust fund reserves in private securities. Many fear that such investments could disrupt or destabilize financial markets. Others are worried that politicians, both in the executive branch and in the Congress, will be tempted to use reserve investment policy to interfere with markets or meddle with the activities of private businesses.

If there were no way to reduce the risk of political interference to a de minimis level, it would be imprudent to propose private investment of a portion of the trust fund reserves, and I would be adamantly opposed to such a policy. Fortunately, institutional safeguards can be created to provide the necessary protections.

Such an institutional framework should have five elements: first, an independent agency modeled after the Federal Reserve Board should be created and charged with the task of managing the trust fund's investments; second, this agency should be required to select through competitive bids several private sector fund managers, each of whom would be entrusted with investing a portion of the trust fund's reserves that were going to be devoted to private assets; third, these managers could be authorized only to make passive investments—that is, investments in securities of companies chosen to represent the broadest of market indexes, not the standard, but rather a Wilshire 5000 or even a broader index; fourth, Social Security's investments should be commingled with the funds that private account holders have invested in the same index funds that the managers chosen by the agency offer to the public; and finally, the fund managers should be required to vote Social Security shares solely to enhance the economic interests of future Social Security beneficiaries.

All of these five elements, each of them, should be established in law, not through regulation, not through some measure that would be easy to change.

As Mr. Smith pointed out, Congress can always change laws. There is a risk here, one which could be reduced if this were placed in a constitutional amendment, but I would say that that is going too far.

I think that this set of institutional arrangements, if established in law, should be sufficient to insulate the trust fund investment decisions from political pressures and provide payroll tax contributors with a fair return on the payments that they are making to the system.

Thank you, Mr. Chairman.

[The prepared statement of Robert D. Reischauer follows:]

PREPARED STATEMENT OF ROBERT D. REISCHAUER [1], SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to discuss with you the issues raised by proposals to invest a portion of Social Security's reserves in private securities. My statement addresses three questions:

- Why do the Administration and others believe it would be helpful to diversify the portfolio of assets held by the Social Security trust fund?
- What legitimate concerns are raised by investing trust fund reserves in private securities? and
- Are there ways to address these concerns?

Why invest in private securities?

It is an unpleasant yet inescapable reality that there are three, and only three, ways to close Social Security's long run fiscal deficit. Taxes can be raised, benefits can be reduced, or the return on the trust fund's reserves can be increased. Recently, some have suggested that a fourth way exists, one that avoids unpleasant choices. This route would be to devote a portion of the projected budget surpluses to Social Security. However, transferring resources from the government's general accounts to Social Security would only shift the locus of the inevitable adjustments. Rather than boosting payroll taxes or cutting Social Security benefits sometime in the future, income taxes would have to be higher or non-Social Security spending lower than otherwise would be the case.

Because neither the public nor lawmakers have greeted the prospect of higher taxes or reduced spending with any enthusiasm, the option of boosting the returns on Social Security's reserves is worth close examination. While higher returns can not solve the program's long run financing problem alone, they can make the remaining problem more manageable.

Since the program's inception, the law has required that Social Security reserves be invested exclusively in securities guaranteed as to principal and interest by the federal government. Most trust fund holdings consist of special nonmarketable Treasury securities that carry the average interest rate of government notes and bonds that mature in four or more years and are outstanding at the time the special securities are issued. In addition to their low risk, these special issues have one clear advantage. They can be sold back to the Treasury at par at any time—a feature not available on publicly held notes or bonds, whose market prices fluctuate from day to day. They also have one big disadvantage—they yield relatively low rates of return.

It is not surprising that, when the Social Security law was enacted, policymakers viewed government securities as the only appropriate investment for workers' retirement funds. They were in the midst of the Great Depression. The stock market collapse and widespread corporate bond defaults were vivid in people's memories. Many believed that a mattress or a cookie jar was the safest place for their savings.

For many years, the restriction placed on trust fund investment made little difference because Congress decided, before the first benefits were paid, to forgo the accumulation of large reserves that were anticipated under the 1935 law. Instead, Congress voted in 1939 to begin paying benefits in 1940 rather than 1942, boost the pensions of early cohorts of retirees, and add spouse and survivor benefits. The system was to operate on a pay-as-you-go basis.

Legislation enacted in 1977 called for moving from pay-as-you-go financing to "partial reserve financing" with the accumulation of significant reserves. These reserves failed to materialize because the economy performed poorly. Further legislation in 1983, together with improved economic performance, subsequently led to the steady growth of reserves. By the end of 1998, the program had built up reserves of $741 billion, roughly twice annual benefits. Under current policy, these reserves are projected to grow to more than $2.5 trillion—about 3.4 times annual benefits—by 2010. As reserves have grown, the loss of income to Social Security from restrict-

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[1] Senior Fellow, The Brookings Institution. This statement draws on *Countdown to Reform: The Great Social Security Debate,* by Henry J. Aaron and Robert D. Reischauer (The Century Foundation Press, 1998). The views expressed in this statement should not be attributed to the staff, officers, or trustees of the Brookings Institution.

ing its investment to relatively low-yielding special Treasury issues also has increased.

The restriction that has been placed on Social Security's investments is unfair to program participants, both workers paying payroll taxes and beneficiaries. To the extent that trust fund reserve accumulation adds to national saving, it generates total returns for the nation equal to the average return on *private* investment, which runs about 6 percent more than the rate of inflation. By paying Social Security a lower return—a return projected to be only 2.8 percent more than inflation over the next 75 years—the system denies workers a fair return on their investment. As a consequence, either the payroll tax rate has to be set higher than necessary to sustain any given level of benefits or pensions have to be lower than would be the case if the program's reserves received the full returns they generate for the economy.

The restriction placed on the trust fund's investments has had another unfortunate consequence. It has added considerable confusion to the debate over alternative approaches to addressing Social Security's long-run fiscal problem. Advocates of various privatization plans argue that their approaches are superior to Social Security because they provide better returns to workers. In reality, the returns offered by these structures look better only because the balances they build up are invested not in low-yielding Treasury securities but rather in a diversified portfolio of private securities. If Social Security were unshackled, its returns would not just match, but almost certainly exceed, those realized by the various reform proposals.

There exists a very simple mechanism for compensating Social Security for the restrictions that are placed on its investment decisions. Each year, Congress could transfer sums to the trust fund to make up the difference between the estimated total return to investment financed by trust fund saving and the yield on government bonds. This could be accomplished with a lump sum transfer or by agreeing to pay a higher interest rate—say 3 percentage points higher—on the Treasury securities held by the trust fund. The transfer required to make up the shortfall in 1998, when the average trust fund balance was approximately $700 billion, would have been about $23 billion, more than two and one-half times the amount that is transferred to the trust fund from income taxes on benefits.[2]

While general revenue transfers to social insurance plans are commonplace around the world, they have been controversial in the United States.[3] Some would oppose such a transfer, arguing that general revenue financing would weaken the program's social insurance rationale through which payroll tax contributions entitle workers to benefits. Others would object to the tax increases or spending cuts needed to finance the general revenue transfer. Still others would question the permanence of such transfers, especially if the budget debate begins to focus on maintaining balance in the non-Social Security portion of the budget, out of which the transfers would have to be made.

An alternative approach would be to relax the investment restrictions on Social Security and allow the trust fund to invest a portion of its reserves in private stocks and bonds. Such investments would increase the return earned by the reserves and reduce the size of future benefit cuts and payroll tax increases. Shifting trust fund investments from government securities to private assets, however, would have no direct or immediate effect on national saving, investment, the capital stock, or production. Private savers would earn somewhat lower returns because their portfolios would contain fewer common stocks and more government bonds—those that the trust funds no longer purchased. Furthermore, government borrowing rates might have to rise a bit to induce private investors to buy the bonds that the trust funds no longer held.[4] Nevertheless, the Social Security system would enjoy the higher returns that all other public and private sector pension funds with diversified portfolios realize.

Concerns about investment of trust fund reserves in private securities

In 1935, Congress ruled out trust fund investments in private stocks and bonds for good reasons. First, policymakers were concerned that the fund's managers might, on occasion, have to sell the assets at a loss, a move that would engender

[2] This estimate is based on the difference between the estimated long-run returns on government securities and private assets, not on the actual differences during 1998.

[3] General revenues have been used in Social Security in limited ways. The allocation of revenues from income taxation of Social Security benefits is an application of general revenues. So were payments made to provide Social Security earnings credits for the military. In addition, when minimum Social Security benefits were eliminated in 1981, they were preserved for those born before 1920 and financed through a general revenue transfer.

[4] With $3.7 trillion in outstanding debt, an increase in borrowing costs of ten basis points (0.1 percentage points) would raise annual federal debt service costs by $3.7 billion.

public criticism. Second, they feared that if the fund had to liquidate significant amounts of securities, these sales might destabilize markets, depressing the value of assets held in private portfolios and upsetting individual investors. An even more important consideration was that they feared that politicians—like themselves—might be tempted to use reserve investment policy to interfere with markets or meddle in the activities of private businesses.

The concerns that Congress had in 1935 were certainly legitimate ones. But conditions have changed over the past 64 years in ways that reduce their saliency. Stock and bond markets are far larger, less volatile, and more efficient now than they were in the 1930s. Trust fund investment activities, therefore, are less likely to disrupt markets. Moreover, the trust fund is unlikely to be forced to sell assets at a loss because the fund has significant and growing reserves, most of which under the various proposals that call for trust fund investment in private securities would continue to be held in special Treasury securities. The trustees would almost certainly sell the fund's government securities to get past any short-run gap between benefit expenses and revenues.

On the other hand, the pressures special interests place on lawmakers and the stresses imposed by reelection are probably greater now than they were in the past. For these reasons, many justifiably continue to be concerned about possible political interference in trust fund investment activities. Chairman Greenspan of the Federal Reserve Board has stated that he does not "believe that it is politically feasible to insulate such huge funds from government direction." Others have been less judicious, charging that equity investment by the trust fund "amounts to nationalization of American industry" and "would threaten our freedom."

Those who oppose trust fund investment in private securities point to the record of some private and state government pension funds that have chosen to use social, as well as economic, criteria to guide their investment policies. In addition, some of these pension funds have voted the shares of companies whose stock they own to further social objectives, ones that might sacrifice some short- or long-run profits. The fear is that the Social Security trustees might be subject to similar pressures. Congress could force them to sell, or not buy, shares in companies that produce products some people regard as noxious, such as cigarettes, alcoholic beverages, or napalm. Similarly, Congress could preclude investments in firms that engage in business practices some regard as objectionable, such as hiring children or paying very low wages in the company's foreign factories, polluting the environment, or not providing health insurance for their workers. Critics also fear that the trust fund might retain shares in such companies and use stockholder voting power to try to exercise control over these firms.

Safeguards to protect trust fund investment decisions from political pressures

If there were no effective way to shield trust fund investment decisions from political pressures, the advantage of higher returns that a diversified investment strategy would yield would not be worth the price that would have to be paid. However, experience suggests both that concerns about political interference are exaggerated and that institutional safeguards can be constructed that would reduce the risk of interference to a *de minimis* level.

A number of federal government pension funds now invest in private securities. They include the Thrift Saving Plan for government workers and the pension plans of the Federal Reserve Board, the U.S. Air Force and the Tennessee Valley Authority. The managers of these pension funds have not been subject to political pressures. They have pursued only financial objectives in selecting their portfolios and have not tried to exercise any control over the companies in which they have invested.

Of course, the fact that the managers of smaller government pension funds have not been subject to political pressures provides no guarantee that the much larger and more visible Social Security system would enjoy a similar fate. Special interests might seek Congressional sponsors for resolutions restricting investments more for the publicity such limits would provide their cause than for any economic impact the directive might have if carried out. In addition, some Members might feel obliged to propose restrictions against investing in corporations that have been found to violate anti trust laws, trade restrictions, workplace health and safety regulations, or other federal limits. Political pressures might cause others to pressure the trustees to exclude investments in companies that have closed a plant in their district and moved their production facilities and jobs abroad.

For these reasons, it would be essential to enact legislation that would create a multi-tiered firewall to protect trust fund investment decisions from political pressures, one that would forestall efforts by Members of Congress or the executive branch from using trust fund investments to influence corporate policy. The first tier of such an institutional structure should be the creation of an independent agency charged with managing the trust fund's investments. This board—which could be called the Social Security Reserve Board (SSRB)—could be modeled after the Federal Reserve Board, which for over eight decades has successfully performed two politically charged tasks—controlling growth of the money supply and regulating private banks—without succumbing to political pressures. Like the governors of the Federal Reserve, the members of the SSRB should be appointed by the president and confirmed by the Senate. To ensure their independence, they should serve staggered terms of at least ten years in length. Congress should be empowered to remove a board member from office only if that member was convicted of a serious offense or failed to uphold their oath of office, not because Congress disliked the positions taken by the member. As is the case with the Federal Reserve Board, the SSRB should be given financial independence. This could be ensured by allowing it to meet its budget by imposing a tiny charge on the earnings of its investments. Under such an arrangement, neither Congress nor the executive branch could exercise influence by threatening to withhold resources.

A second tier of protection should be provided by limiting the discretion given to the SSRB. The primary responsibility of the board should be to select, through competitive bids, several private sector fund managers, each of whom would be entrusted with investing a portion of the fund's reserves. Depending on the amount invested, somewhere between three and ten fund managers might be chosen. Contracts with the fund managers would be rebid periodically and the board would monitor the managers' performance.

A third tier of insulation from political pressures should be provided by authorizing fund managers only to make passive investments. They would be charged with investing in securities—bonds or stocks—of companies chosen to represent the broadest of market indexes, indexes that reflect all of the shares sold on the three major exchanges. In other words, the trust fund's investment would be in a total stock market index such as the Wilshire 5,000 or Wilshire 7,000 index. If bonds were included in the investment mix, the appropriate guide might be the Lehman Brothers Aggregate (LBA) index. Unlike actively managed mutual funds, there would be no discretion to pick and choose individual stocks and, therefore, no window through which political or social considerations could enter.

A fourth layer of defense should be provided by requiring that Social Security's investments be commingled with the funds that private account holders have invested in index funds offered by the managers chosen by the SSRB. These private investors would object strenuously if politicians made any attempt to interfere with the composition of the holdings of their mutual fund.

Fifth, to prevent the SSRB from exercising any voice in the management of private companies, Congress should insist that the several fund managers selected by the SSRB vote Social Security's shares solely to enhance the economic interest of future Social Security beneficiaries.

To summarize, this set of five institutional restraints would effectively insulate fund management from political control by elected officials. Long-term appointments and security of tenure would protect the SSRB from political interference. Limitation of investments to passively managed funds and pooling with private accounts would prevent the SSRB from exercising power by selecting shares. The diffusion of voting rights among several independent fund mangers and the requirement that the managers consider economic criteria alone would prevent the SSRB from using voting power to influence company management. In short, Congress and the president would have no effective way to influence private companies through the trust fund unless they revamped the SSRB structure. That would require legislation which would precipitate a national debate over the extent to which government, in its role as custodian of the assets of the nation's mandatory pension system, should interfere in the private economy. Framed this way, there would be strong opposition to such legislation.

While nothing, other than a constitutional amendment, can prevent Congress from repealing a previously enacted law, the political costs of doing so would be high. Furthermore, if Congress is disposed to influence the policies of private businesses, it has many far more powerful and direct instruments to accomplish those ends than through management of the Social Security trust funds. The federal government can tax, regulate, or subsidize private companies in order to encourage or force them to engage in or desist from particular policies. No private company or lower level of government has similar powers.

Conclusion

Allowing the Social Security system to invest a portion of its growing reserves in private assets will increase the returns on the trust fund balances and reduce the size of the unavoidable payroll tax increases and benefit reductions that will be needed to eliminate the program's long-run deficit. Concerns that political interests might attempt to influence trust fund investment decisions are legitimate but institutional safeguards can be enacted into law that would reduce the possibility of such interference to a *de minimis* level.

Mr. OXLEY. Thank you.
Mr. John?

STATEMENT OF DAVID C. JOHN

Mr. JOHN. Thank you. I am delighted to be here.

I am not going to speak about the government investment of the trust fund. That actually has been handled and will be handled subsequently to great extent. I am going to speak about the lesser known, the lesser discussed element of the President's plan, which is the USA accounts.

We salute the President for including an element that does allow Americans to increase their rate of return. The average worker does need more to show for a lifetime of work than just memories and a small monthly check.

There are, however, a couple of problems with the way it has been proposed at this point. Problem No. 1 is that it does not have stable source of funding. While I am an economist myself, or at least I pretend to be on occasion, I am well aware that a 15-year economic forecast is slightly less valuable than a 15-year weather forecast. And I am not going to plan any picnics based on it.

If you look at the CBO forecast for the cumulative budget surplus from fiscal year 1999 to 2008, in August it stood at $1.54 trillion. Now, last month it stood at $2.65 trillion, which is a 72 percent increase. That can go down as well as it goes up, and if you look at the technical notes in the back of the CBO numbers, you will see that there actually is room for that kind of a decline.

This is too important a program to fund just out of a surplus, because what will we do at the inevitable time when the surplus ends, or when the surplus does not meet the requirements. We are faced with one of two situations. Either we tell the average worker we are sorry, we are not going to be able to meet these goals that we have set up for ourselves; or No. 2, that we have created another new expensive entitlement program for our children to end up paying for.

Instead, it would make much more sense to perhaps start these with the budget surplus, and then move them, whether it is on a contingency basis or a permanent basis, and to carve out of a portion of the Social Security taxes that an individual now pays. It basically could be called perhaps Social Security Part B, Social Security Plus, and that is up to the press secretaries and the marketeers to put together. But it is something that could be put together relatively easily.

Second, there is a question while the administration has not given us any indication of how they are going to structure these, what they have talked about is $100 plus some sort of a match. Now, Mark Sanford earlier mentioned the whole question of what do you do with a lower-income individual. If you look at 401(k) studies, you find that there is a direct correlation between income level and the ability to make a matching contribution. When it comes right down to it, your average worker is much more interested right now in paying the kids' doctor bills than necessarily putting away something for 40 years in the future. Instead, as I say, a carve-out perhaps with a minimum amount of $500, $250, whatever Congress sets up, would be much more appropriate.

Now, the next remarks will apply to both the USA accounts and to any form of an individual account within Social Security.

How do you regulate? There is a direct correlation between the administration costs of any account and how complex the account is, and the types of investment return that it offers, investment options that it offers. For instance, a simple return like the TSP which has three investment options, one of which is the stock index fund, is probably the lowest possible cost, although TSP's administrative costs are artificially low because it does not include any costs of collecting the money.

There is a question about the size of funds. What is the maximum size of a mutual fund? This is something that has been under discussion for a number of years. Nobody is quite sure what it is at this point, but we are pretty sure that there is one.

If you look at TSP, for instance, TSP's stock index fund is about $30 billion in assets. That $30 billion is about a third of a $91 billion fund. If you have one fund, if you have the investment option that is done by TSP, at some point you are going to reach this maximum.

Now, how do you deal with that possibility? When it comes right down to it, a stock index fund is a stock index fund is a stock index fund. It really does not matter assuming that you are investing in the same index who offers it. It would be very possible to allow a number of different companies to offer it whether it is to an employer or to an individual worker.

If you look at the United Kingdom, they have a way where the government collects the taxes, holds it for a year in a government trust fund paying government bond rate, and then distributes it. There is a paper by Fred Goldberg which has just been published by the National Bureau of Economic Research which also discusses this option.

Australia has another version where the money is sent directly by the employer and then any sort of compliance is checked at tax time. This is somewhat similar to what we do when you change your IRA from one individual to another, or one provider to another. It would be fairly simple to allow choice.

Now, in order to allow choice we would have to have a certain level of licensing. It is going to have to be objective, much the same as the SEC's licensing of a mutual fund now or a bank license or a credit union license or something along that line. We are not necessarily interested in Joe's Bar and Pension Plan. We are interested in something that is far better than that.

Here are four objectives or four criteria which might be some of the ones that the subcommittee would consider.

No. 1 would be capital adequacy for fairly obvious reasons. We are not interested in having someone's provider be subject to sudden reverses.

No. 2, managerial expertise. Again, fairly obvious.

No. 3 is a clear and advanced disclosure in writing of all types of fees that would be associated with this account. Notice here I am not saying anything about regulating the fees. Again, you are talking about what is essentially the same type of mutual fund being provided by a number of different people, and it would be quite possible to go through and check the fees in advance and make a choice depending on that.

And last, but not least, a clear regular statement, annual or quarterly. This particular one happens to be an Australian statement that is offered by DeZerk Fund, which very clearly lists how much money has gone in, how much tax has been paid, what the return is and what the fees are. This again is perhaps something that is fairly simple to structure. I would recommend it.

Now, of course. there would be a need to regulate and a need to examine these entities on a fairly regular basis to make sure that they are continuing to comply, and as with current structures in banking and others, in the event that there is a failure you will have to be able to transfer the accounts to another level.

I look forward to any questions you might have.

[The prepared statement of David C. John follows:]

PREPARED STATEMENT OF DAVID C. JOHN, SENIOR POLICY ANALYST FOR SOCIAL SECURITY, THE HERITAGE FOUNDATION

I appreciate the opportunity to appear before you today to discuss the market impacts of the President's Social Security proposal. While I am the Senior Policy Analyst for Social Security 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.

This hearing is particularly important because of the subcommittee's expertise in the workings of financial markets. The success or failure of both the President's Universal Savings Account proposal and any personal retirement account component of Social Security will largely depend on their structure and how they are regulated.

This morning, I will focus on three major areas. First, my testimony will briefly discuss the potential dangers of having the government invest part of the Social Security trust fund in the equity markets. Second, the President's Universal Savings Account plan will be considered, and third, I will examine ways to structure individual accounts to reduce administration costs and provide adequate consumer protections.

However, I would like to begin by giving credit where credit is due. While I have some strong criticism of aspects of the President proposal, it has several positive features.

By recognizing the importance of allowing Americans to increase the rate of return on their Social Security retirement taxes, President Clinton has taken a major step towards increasing the retirement security of working Americans. A conservative portfolio divided evenly between stocks and super-safe government bonds would yield returns of 5 percent, far more than Social Security's current average annual return on retirement taxes of 1.2 percent.

Also, the White House recognizes that personal retirement accounts are feasible, cost effective, and safe. They know that it will be fairly simple to solve the logistical problems associated with creating personal retirement accounts, and that these accounts can be structured to be both inexpensive and low risk.

Government Investment of the Social Security Trust Fund

The President's proposal to have a government agency invest portions of the Social Security trust fund raises serious questions about political interference in investment decisions. Allowing a government agency, no matter how it is structured, to invest Social Security funds in equity markets sets up a situation where the long-term needs of future retirees could be subordinated to short-term political goals.

Federal Reserve Board Chairman Alan Greenspan says that it would be almost impossible to insulate those investment decisions from political interference. To prove his point, the Reverend Jesse Jackson told the House Ways and Means Committee recently that Social Security funds should not be invested in tobacco and liquor companies or gun manufacturers. Also, there are news reports that the AFL-CIO is threatening to pull its pension funds from any funds manager that supports establishing individual retirement accounts as a part of Social Security. This is a clear example of the pension needs of union members taking second place to that organization's political agenda.

Unfortunately, history proves the potential for political interference from both sides of the political spectrum. The Texas State Board of Education recently sold 1.2 million shares of Disney because it disapproved of the content of certain Disney films. In another instance, Minnesota lost $2 million in pension investments when it sold its tobacco stocks.

Political influence is possible even if stock investments were limited to index funds containing 500 or more stocks. Index funds can be developed using any criteria, and their composition changes over time because of mergers, bankruptcies, and new technologies.

It would be extremely easy to develop an index fund of 1000 stocks that left out tobacco companies, gun manufacturers, companies that had aroused the ire of organized labor, or those who had supported the wrong candidate in the last election. There is even a chance that such a fund would earn almost as much as traditional market index funds. However, it could just as easily earn much less. In politics there is always the temptation to live for today instead of for the future, and tomorrow's retirees should not see their Social Security held hostage to the next election.

Universal Savings Accounts

While I applaud the concept of allowing workers to have a new way to invest for their retirements, USA accounts do nothing to save Social Security, and could become an expensive new entitlement program.

The White House says that these accounts will be financed by the surplus, but former Congressional Budget Office head June O'Neill warned that the era of budget surpluses could be fairly short. While we all hope that the projections of lasting budget surpluses will be accurate, any long-term economic forecast is volatile. Just last August, CBO projected the aggregate surplus for fiscal years 1999 through 2008 to be $1.54 trillion. The January 1999 aggregate projections for the same period were $2.65 trillion, a 72 percent increase. Over the next few years, these forecasts could just as easily drop.

When the inevitable economic slowdown hits, deficits are very likely to return. At that point, either federal contributions to the USA accounts will stop, or the government could convert them into another expensive entitlement program for our children to pay for.

The retirement security of American workers is far too important to base on our hope for a future surplus. While it might make sense to start funding the USA accounts with the surplus, Congress should then shift to funding them with a proportion of the existing taxes that workers already pay to Social Security. That way, once the surpluses end, these accounts can continue to grow, and with them, the retirement incomes of American workers.

In addition, rather than creating a whole separate program, it would make much more sense to make these accounts part of Social Security. The new "Social Security Part B" would make it easier to consider these accounts as part of a comprehensive solution to deal with Social Security's existing problems. As Comptroller General David Walker has pointed out, the President's overall approach to Social Security does nothing to change the program's projected cash flow imbalance. At some point, Congress will have to take steps to deal with this problem.

Finally, how these accounts are structured is extremely important. While the Administration has not announced specific plans, it appears that the government would transfer $100 annually into each American's account. Workers below a certain income level also being eligible for a government match of money they deposit in the accounts, with those at lower income levels receiving a greater match of their deposits. This is superficially attractive, but somewhat misguided. Lower income workers have very little excess income that could be saved for future retirements. Studies show that even when matched, contributions to existing retirement plans are directly related to the income of the contributor. The lower the income of the worker, the lower the probability that this person will contribute to their retirement plan.

Simply put, for these workers, paying the kid's doctor bills or the mortgage today is much more important than saving for an event far in the future. They simply do not have the extra money. As a result, including an income match will result in a subsidy to middle class taxpayers without really benefiting those who need a higher retirement income the most.

Structuring and Regulating Personal Retirement Accounts

This part of my testimony applies to both Universal Savings Accounts and a personal retirement account segment within Social Security. How these accounts are structured and regulated is as important a decision as whether they exist in the first place.

Structuring the accounts: In order to reduce administrative costs and potential investor confusion, initially, it would be best to only offer three investment options. These could be a broad-based stock index fund, a bond index fund, and some sort of government bond fund, perhaps using the new inflation-indexed Series I United States Savings Bonds.

This decision is important for two reasons. First, studies have proved that administrative costs are directly related to the complexity of the account and to the level of services offered. Stock index funds, which are computer traded, have extremely low administrative costs. Overall, an account that offers only a few, simple investment options, one of which is a stock index fund, will provide the best tradeoff between potential returns and low administrative costs. As the Australian experience has shown, this type of account can be offered for an annual administrative cost of 0.7 percent of assets or less.

Second, this structure reduces risk. Your brother-in-law's hot stock tip is not usually the best road to retirement security. An index fund gives the returns associated with the equity markets without the hazard and expense of picking individual stocks. As time goes on, additional investment options can be added, some of which could have greater risk.

Allowing the Choice of a Funds Manager: Regardless of which funds manager is offering it, equity funds tied to a specific stock index are all pretty much identical. Over time, these retirement savings accounts will attract hundreds of billions of dollars worth of savings and retained earnings. This pool of money will almost certainly be too large to be managed by any one funds manager. For that reason, rather than having everyone invest in one big stock index fund, as is currently the practice in the federal Thrift Savings Plan (TSP), it would be better to allow individuals to purchase their stock or bond index funds from an approved list of funds managers.

Moving Funds to the Manager: There are several ways to send retirement savings to a funds manager. In the United Kingdom, retirement taxes are collected by the government and kept for a year in a government bond fund while income data is being collected. Once it is clear how much is due to each person, the taxes and accumulated interest are sent to that individual's funds manager and credited to his or her specific account. Several of the Social Security reform plans that are before Congress now use a similar mechanism.

This method could be used for both Universal Savings Accounts and an individual account component of Social Security. It has the advantage of utilizing Social Security's existing method of collecting individual income data, while still allowing the greatest number of private funds managers to be involved in the actual investment process.

Regulating Funds Managers: It is not in anyone's interest to have "Joe's Bar and Pension Fund" managing retirement savings. Only established funds managers who can meet several strict, but objective, standards should be allowed to accept this money.

The Securities and Exchange Commission (SEC) has both an admirable history and the expertise to regulate funds managers, and either it or a similar agency should have this responsibility. There are four standards that potential funds managers should meet. They are:

- *Capital Adequacy:* The manager should have sufficient capital invested in the firm to ensure stability and the ability to survive market fluctuations.
- *Professional Expertise:* Only qualified and experienced professionals should be allowed to manage these retirement savings accounts.
- *Disclosure of Fees:* All fees and costs must be clearly disclosed in writing before any money is accepted.
- *Regular Statements:* All account owners must receive regular statements in clear and simple language that discloses the status of their accounts, including the amount of contributions, the rate of return for each investment option, and the exact amount of any fees that were paid.

Funds managers should be regularly examined to ensure that they continue to meet these qualifications and any other rules that the SEC finds to be necessary. However, there is no need to apply the overly restrictive ERISA regulations to these accounts. In addition, there could be a requirement that the principle (but not investment gains) would be covered against loss by a private insurance policy that would be payable only at retirement. This would provide both an additional level of security and reduce the possibility that individuals will become anxious because of temporary market dislocations.

Conclusion

Mr. Chairman, it is time for all Americans to receive the benefits of our economy. Over the last 12 months, the S&P 500 went up 23.3 percent. The NASDAQ composite went up 36.6 percent. Corporate bonds yield 6.4 percent a year, and the government's Series I Savings Bonds yield 5.05 percent. However, Social Security, the average worker's retirement fund, has annual returns of only about 1.2 percent a year.

It is only fair to allow every worker, no matter what his or her income level to share these returns. Americans should have more to show for a lifetime of work than just memories and a small monthly check.

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Mr. OXLEY. Thank you, Mr. John.

We will welcome back Mr. Glassman.

STATEMENT OF JAMES K. GLASSMAN

Mr. GLASSMAN. Thank you, Mr. Chairman, members of the committee. I Am honored to be here today, and I commend you for holding this hearing to address this profoundly serious subject.

It is appropriate that the title of the subcommittee is Finance and Hazardous Materials because I think this proposal to invest taxes in the stock market falls under both rubrics. It is hazardous; it is dangerous. As Alan Greenspan, the chairman of the Federal Reserve Board, said on Capitol Hill in July, government investing would, quote, "have far-reaching dangers for a free American economy and a free American society."

The President says only a small portion, actually a little more than one-fifth, of each year's transfers to the Social Security trust fund will go to stocks. But the sums, the total sums are enormous. By 2014, according to the actuaries, the U.S. Government will own $921 billion worth of stock in American corporations.

To put that figure into perspective, California's Public Employee Pension plan, the largest in the Nation, has assets of $150 billion. The pension plan sponsored by General Motors, the largest corporate plan, has $100 billion. The largest mutual fund is $80 billion. And currently, $3 trillion is invested in mutual, in stock mutual funds in this country.

Social Security actuaries calculate that between 2001 and 2020, the government will own on average 3.7 percent of the total value of the shares on the stock market. Ownership of stock by the government first raises an important matter of political philosophy. At a time when much of the rest of the world has been turning ownership of State-owned enterprises over to the public in the form of stock issues, and also moving toward private accounts in replacement of part, at least part of Social Security, the President's proposal moves the United States in exactly the opposite direction.

I do not want to sound overly dramatic or inflammatory, but, by definition, this plan is a step toward the dictionary definition of socialism, which is government ownership of a means of production.

Now, most large firms on the major exchanges have broadly diverse ownership, which is one of the strengths of the American corporate system. Take, for example, Merck and Company, the pharmaceutical house. It has only two shareholders with a stake of more than 1 percent—Fidelity which has 2.3 percent, and Barclay's Bank, which is a major manager of index funds, at 1.5 percent.

Assuming that the Federal Government's ownership stake is spread across all corporations equally, it would hold 3.7 percent of the stock of Merck, or 50 percent more shares than the largest owner currently holds.

By the same analysis, it would become the largest owner of shares in Exxon Corporation, the second largest owner of J.P. Morgan and Company, and the largest institutional owner, after the three individual founders, of Microsoft Corporation.

The administration proposes to insulate the government from the direction of companies whose stock it owns by setting up a neutral board. But as Chairman Greenspan told Congress, I do not know any way you can essentially insulate government decisionmakers from having access to what will amount to very large investments in American private industry. And certainly the experience of State and local governments is not encouraging.

A few years ago the huge California State pension plan, Calpers, brought its ownership weight to bear in pushing out the CEO of General Motors. In the 1980's, 30 States prohibited the investment of government employee pension funds in companies that did business in South Africa. In a study of 50 State pension plans between 1985 and 1989, Roberta Romano of Yale concluded that public pension funds are subject to political pressures to tailor their investments to local needs.

And drawing on a reference work by James Packard Love, the Cato Institute's Michael Tanner recently concluded that 23 percent of State and local government employee pension systems have prohibitions against investment in specific types of companies, and 42 percent have restrictions targeting some portion of investments to projects designed to stimulate the local economy or create jobs.

So let's just use some common sense here. Imagine what might be called a passive system of investing tax dollars only in the companies that comprise the standard Forbes 500 stock index. This seems to be one of the ideas that is on the table. This is an index that is weighted according to market capitalization. In other words, the bigger companies have more weight. The largest stock in the S&P is—guess what?—Microsoft, which is currently being prosecuted by the Justice Department for alleged antitrust violations.

Imagine the government being the largest institutional shareholder in a company that the government is suing.

Next, consider the No. 2 stock in the S&P, General Electric, which owns, among other things, the National Broadcasting Company, NBC. Should the Federal Government be the second largest shareholder in a huge media company?

Consider Philip Morris Companies, which represents 1 percent of the S&P. That would be a $9 billion investment by the Federal Government by the year 2014. Of course, Philip Morris is America's top purveyor of cigarettes. Should the hard-earned money of taxpayers support a firm that makes what many politicians believe to be death-dealing products?

To choose the S&P is to give excessive weight to large companies.

Now, there is also a proposal instead to use the Wilshire 5000, which is a broader index. But the Wilshire is also capitalization weighted, which means, again, large companies get most of the money. Is it fair to America's smaller firms, does it make political sense, does it make social sense to have this kind of an investment strategy?

And why invest in listed companies at all? Few of them are run by members of minority groups or by women. And these are precisely the companies that do not need the extra capital that the government would provide.

Now, is this a new idea? I believe that it is, government investing in the stock market. You have heard previously and you heard from the President that the government would only be doing what a private or State government pension would do. This is disingenuous. No State runs a pension system for all of its citizens. Instead, what States do is they make provision for the retirement of their employees who voluntarily agree to accept employment from the State.

Social Security, on the other hand, is universal and mandatory. It uses tax dollars of every worker, whether that person works for the Federal Government or not.

Let me just conclude by saying that in the end, the main threat from government investing in the stock market is the inevitable political pressure that will be brought to bear. For the government to use tax dollars to buy shares of private American corporations is to take a giant step in precisely the wrong direction. It is also unnecessary.

If higher returns on retirement contributions are needed, and I believe they are, individuals are fully capable of seeking them in a system that replaces part or all of Social Security with private investment accounts that Americans would own themselves.

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

[The prepared statement of James K. Glassman follows:]

PREPARED STATEMENT OF JAMES K. GLASSMAN, DEWITT WALLACE-READER'S DIGEST FELLOW IN COMMUNICATIONS IN A FREE SOCIETY, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

GOVERNMENT INVESTING IN THE STOCK MARKET

"DANGERS FOR A FREE AMERICAN ECONOMY AND A FREE AMERICAN SOCIETY."

Mr. Chairman, members of the committee:

My name is James K. Glassman. I am a columnist on financial, economic and political topics for the *Washington Post*. My column appears in many other newspapers throughout the country and the world, including the *International Herald Tribune*. I am also host of "TechnoPolitics," a weekly program on PBS TV that frequently addresses the interaction between finance and government. In addition, I am a monthly commentator on PBS's "Nightly Business Report" and a columnist for Intellectual Capital, an electronic magazine on the Internet.

With my collaborator Kevin Hassett, an economist at the American Enterprise Institute who was formerly a senior economist at the Federal Reserve Board, I am currently completing a book on the stock market, to be published in October by Times Books, a division of Random House. While I am not a trained economist, I have been writing about finance and public policy and the relationship between the two for nearly 30 years.

Since October 1996, I have been the DeWitt Wallace-Reader's Digest Fellow at the American Enterprise Institute, a research institution in Washington. Much of my work at AEI has focused on investment aspects of Social Security.

Thank you for allowing me to address the committee this morning.

Nearly One Trillion in Stocks

The quotation below the title of this testimony is a quotation from Alan Greenspan, chairman of the Federal Reserve Board. It underscores the serious nature of the Social Security proposal offered by President Clinton earlier this year. That proposal would profoundly change the relationship between the government and the private sector, the engine of prosperity and hope for all Americans.

In his budget message on Feb. 1, the president proposed investing what he termed a "small portion" of the federal budget surplus over the next 15 years "in the private sector, just as any private or state government pension would do, so that we can earn higher returns and keep Social Security sound for 55 years."

Specifically, according to a Feb. 12 memorandum to the chief actuary of the Social Security Administration:

> "The president's plan calls for transfers to be made from the General Fund of the Treasury of the United States to the Old-Age, Survivors, and Disability Insurance (OASDI) trust funds for each year 2000 through 2014. The amount of the transfer each year would be specified in law as a percentage of the OASDI effective taxable payroll. In each year 2000 through 2014, 21 percent of the transfer would be used to purchase stock and 79 percent would be used to purchase special interest-bearing obligations of the Treasury. All dividends would be reinvested in stock until the market value of all stock held by the OASDI trust funds reached 14.6 percent of total OASDI trust fund assets. Thereafter, the percentage of total trust fund assets that is held in stocks would be maintained at 14.6 percent."

While the president says that only a "small portion"—actually a little more than one-fifth—of each year's transfers to the trust fund will go to stocks, the sums are enormous. By 2014, according to the actuaries, the U.S. government will own $921 billion worth of shares of American corporations.

To put this figure in perspective: California's public employee pension plan, the largest in the nation, has assets of about $150 billion, and the pension plan sponsored by General Motors, the largest corporate plan in the country, had assets of about $100 billion. The largest single mutual fund—Vanguard Index 500—has assets of about $80 billion.

The Social Security actuaries calculate that, between 2001 and 2030, the government will own, on average, 3.7 percent of the total value of the shares on the stock market.

Defining Socialism

Ownership of stock by the government raises deep and troubling issues.

The first is a matter of political philosophy: At a time when much of the rest of the world has been turning ownership of state-owned enterprises over to the public, in the form of stock issues, the president's proposal moves the United States in the opposite direction.

I do not want to sound overly dramatic, but, by definition, the plan is a step toward the dictionary definition of socialism: government ownership of the means of production.

Thus, Congress must first answer this question: Should the federal government have an ownership stake in private corporations?

My own answer is no, but this is an issue of first principles that all Members must decide themselves.

Second, even if you accept that the government should own shares of private companies, should it own so much?

Most large firms that are traded on major exchanges have broadly diverse ownership—which is one of the strengths of the American corporate system. For instance, Merck & Co., the pharmaceutical house, has only two shareholders with a stake of more than 1 percent: Fidelity Management, the largest mutual fund house in the world, at 2.3 percent, according to Technimetrics, Inc., and Barclays Bank, a major manager of index funds, at 1.5 percent. Assuming that the federal government's ownership stake is spread across all corporations equally, it would hold 3.7 percent of the stock of Merck—or 50 percent more shares than the largest owner currently holds.

Let's look at some more examples. General Electric is America's largest industrial firm and the largest company on the New York Stock Exchange, with a market capitalization of $337 billion. Fidelity is its top owner, with a 4.0 percent share. Assuming the current stakes remain the same, the federal government would become the second-largest owner, at 3.7 percent, well ahead of Barclays at 2.9 percent and Bankers Trust at 1.7 percent.

It would also become the largest single owner of shares in Exxon Corp., the second-largest owner of J.P. Morgan & Co., the New York-based bank, and the largest institutional owner of Microsoft Corp. (but with a smaller stake than each of the company's three founders).

What does stock ownership mean?

In the American corporate system, stockholders are like voters in the political system. They elect representatives—in this case a board of directors—who in turn select managers to run the company. But the essential decisionmaking power in a corporation resides in the stockholders on a one-share, one-vote basis.

Is Insulation Possible?

The administration proposes to "insulate" the government from the direction of the companies whose stock it owns by setting up a neutral board. This board would evidently vote the stock.

But, as Chairman Greenspan has told Congress, "I don't know any way you can essentially insulate government decisionmakers from having access to what will amount to very large investments in American private industry."

Certainly, the experience of state and local governments is not encouraging. A few years ago, the huge state employee pension plan in California, Calpers, brought its ownership weight to bear in pushing out the CEO of General Motors.

More often, political influence is expressed through specific rules and restrictions. For example, in the 1980s, 30 states prohibited the investment of government-employee pension funds in companies that did business in South Africa.

In a study of 50 state pension plans over the period 1985 to 1989, Roberta Romano of Yale University concluded that "public pension funds are subject to political pressures to tailor their investments to local needs, such as increasing state employment, and to engage in other socially desirable investing." She added that investment dollars were directed not just toward "social investing" but toward companies with lobbying clout.

After all, when he was Labor Secretary, Robert Reich urged private pension funds to invest in "economically targeted investments."

Drawing on a reference work by James Packard Love, the Cato Institute's Michael Tanner recently concluded that "23 percent of [state and local government-employee] pension systems have prohibitions against investment in specific types of companies, including restrictions on investment in companies that fail to meet the 'MacBride Principles' for doing business in Libya and other Arab countries; companies that are accused of pollution, unfair labor practices, or failing to meet equal opportunity guidelines; the alcohol, tobacco, and defense industries; and even companies that market infant formula to Third World countries."

Also according to the Love book, "approximately 42 percent of state, county, and municipal pension systems have restrictions targeting some portion of investment to projects designed to stimulate the local economy or create jobs."

One result of the politicization of pension investing in the states is that, as Olivia Mitchell of the University of Pennsylvania found in a study of 200 state and local pension plans during the period 1968 and 1986, "public pension plans earn[ed] rates of return substantially below those of other pooled funds and often below leading market indexes."

No wonder Greenspan told the Senate Banking Committee last July: "I know there are those who believe [government investments] can be insulated from the political process. They go a long way to try to do that. I have been around long enough to realize that that is just not credible and not possible."

Owning Microsoft, Philip Morris

Just use common sense. Imagine what might be called a "passive" system of investing tax dollars only in the companies that comprise the popular Standard & Poor's 500-Stock Index, which roughly includes the 500 largest stocks listed on U.S. exchanges, weighted according to their market capitalizations—or the number of shares they have outstanding times the price per share.

The largest stock in the S&P is Microsoft, which is currently being prosecuted by the Justice Department for alleged antitrust violations. Should the government be the largest institutional shareholder in a company that the government is suing? That would be quite a conflict of interest. Government shareholders might want to vote to settle the lawsuit, or agree to break up the company—even if such a step were not in Microsoft's interest.

Microsoft represents 3.5 percent of the value of the S&P. So, assuming that ratio holds, by 2014, of the government's $921 billion in estimated stockholdings, a total of $32 billion—or nearly $300 per American family—will be invested in Microsoft.

Or consider the number-two stock on the S&P index: General Electric, which owns, among other things, the National Broadcasting Co. Should the federal government be the second-largest shareholder in a huge media company? Under the same S&P formula, Washington would own $29 billion of GE stock in 2014.

Perhaps the trustees on the government investment board could duck the Microsoft and GE problems, but what about a company such as Philip Morris Cos., Inc., which represents about 1 percent of the S&P (a $9 billion investment by 2014). Philip Morris, of course, is America's top purveyor of cigarettes. Should the hard-earned money of taxpayers support a firm that makes what many politicians believe to be death-dealing products.

My guess is that someone will quickly introduce a bill in Congress to forbid investment in companies that sell tobacco products. That will be followed by bills that restrict investing in firms that sell alcohol or run casinos or that operate plants that exploit cheap foreign labor and on and on.

But imagine if, by some miracle, politicians did not restrict ownership, and the federal government ended up with a large stake in Philip Morris. Then, whenever the notion of taxing cigarettes or increasing regulations would arise in Congress, the specter of a conflict would be raised. The legislation might make sense socially, but it would reduce the company's profits and thus hurt America's retirees.

Bias in Choosing an Index

Of course, no investment policy is truly passive. You can put money into an index fund, but you have to choose an index.

To choose the S&P 500 is to give excessive weight to large companies. Currently, there is no firm on the index with a market capitalization below $400 million, only 40 firms on the index that are listed on the NASDAQ exchange and only two that are listed on the American exchange. The S&P 500 includes only one biotech firm and only 13 computer hardware and software companies. It is hardly representative of the U.S. economy as a whole.

Does it really make sense for the earnings of all working Americans to be invested in fewer than 10 percent of all listed public companies and far less than 1 percent of all U.S. firms?

It would be impossible for any investing policy to prevent discrimination against particular regions of the country. Rep. Christopher Cox has pointed out that an S&P investing strategy "would expressively disadvantage Orange County [Calif.]. Our region is teeming with high-tech startups and small-to-medium-sized firms, but is home to only seven Fortune 500 corporations."

There are other indices. The payroll dollars could be invested in the Wilshire 5000 index, comprising every listed stock on the three major exchanges—7,200 of them. Wilshire investing, however, is technically difficult since such small amounts would go into some stocks. Vanguard, the mutual fund house with the largest public Wilshire fund, called Total Stock Market Index Fund, actually invests in only 3,118 stocks, using a computer model to take care of the rest. But should payroll dollars be entrusted to such a model?

Also, the Wilshire, like the S&P 500, is market-cap-weighted, which means that large companies get most of the money. Is that fair to America's smaller firms—and does it make sense as an investment strategy?

And why invest in listed companies at all? Few of them are run by members of minority groups or by women. And these are precisely the companies that don't need the extra capital that the government would provide.

Even if you could launch a successful index investing strategy, it would hardly be passive since each year, as my colleague, Carolyn Weaver of the American Enterprise Institute, points out, "billions of dollars would be pouring into companies without regard to who is polluting what, who is selling what damaging products to children, who has been convicted of violations of the law or is being sued by the federal government, who is operating in a country with offensive human rights policies or dangerous nuclear weapons policies, or . . . who is in dispute with which union, or who is moving jobs abroad or selling products made with child labor."

Advocates of government investing try to argue that it is no big deal. As President Clinton said, the federal government would simply be doing what a "private or state government pension would do." That is disingenuous. No state runs a pension system for all of its citizens. Instead, states make provision for the retirement of their employees, who voluntarily agree to accept employment from the state. Social Security, on the other hand, is universal and mandatory. It uses the tax dollars of every worker, whether he or she works for the federal government or not.

Not the Thrift Savings Plan

Advocates also point to the federal retirement plan, called the Thrift Saving Plan (TSP), as another example of benign government investing in stocks on behalf of employees.

But the TSP, which has only $50 billion in assets, is a defined-contribution plan, which means that employees direct where their retirement savings will go and that they actually own the accounts. When it established the TSP in 1986, Congress explicitly addressed concerns about political manipulation of funds by observing that it was the "inherent nature" of a defined-contribution plan that precluded tampering.

That inherent nature was private ownership. As House and Senate conferees stated in H.R. Conference Report No. 99-606 (1986): "Unlike a defined benefit plan . . . a thrift plan is an employee savings plan. In other words, employees own the money. The money, in essence, is held in trust for the employee and managed and invested in 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 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 an entity including Congress."

Contrast this arrangement with the administration's plan. Payroll tax dollars that go into the Social Security Trust Fund, a general pool of money, controlled by government trustees, would be invested in the stock market—for the general welfare of the fund not for the particular welfare of an individual owner.

This is truly government money, as opposed to the money of an individual with the government acting as a fiduciary.

In fact, it makes me wonder: If stock-market investing by the government is so lucrative, why not have the Treasury issue more bonds at 5 percent and invest the proceeds in the stock market at 11 percent? The answer is obvious: Private investing is not a government function.

By pointing to the TSP, advocates of government investing remind us of an excellent model for a system of private accounts that could replace the current Social Security system. Under the TSP, federal employees have three choices: a stock mutual fund, run by a Barlcay's and based on the S&P 500 and two bond funds. These choices are too limited, but they are a start.

I would be happy to see Americans divert payroll tax dollars into TSP-style accounts that they would own themselves.

The Risks of Stocks Can't Be Changed

But what about the risk of the stock market?

This used to be a major argument against Social Security reform that uses private accounts. For those familiar with extensive scholarly research on the stock market, it was never a realistic objection.

The nature of Social Security investing is that it is long-term. But the stock market has never suffered a decline, even after inflation, over any period of 17 years or longer. Bonds have. The standard deviation—a measure of volatility or risk—for stocks is lower than for bonds or even Treasury bills—over periods of 30 years or longer.

But the argument that stocks are risky hardly seems a viable argument now that President Clinton wants to invest tax dollars in the market.

Still, it is said that government investing in the stock market is somehow less risky than individual investing. In truth, the risk that exists in the stock market exists for all investors—individual as well as government.

It is true that government, through the taxing power, has the resources to provide a backup, or safety net, to individuals. But that would be true even if individuals themselves did the stock-market investing.

And, of course, the backup would be provided not by "the government" but by taxpayers who supply the government with their tax dollars. So, if a market disaster occurred, it would be individual Americans who would foot the bill, either way.

Is government a better investor than individuals? It's possible, but I wouldn't bet on it. Research shows that state and local government-employee pension funds certainly lag the market as a whole. Whose index fund investment would perform better? An individual's? Or the government's? Obviously, their performance would be the same.

My own guess is that, with rare exceptions, individuals would do better—for themselves and their families. They know their own risk tolerance and their own needs. They would likely be more careful, not less—since so much more is at stake.

Think of it this way: Who would do a better job buying your house for you? You yourself or a government agency? Retirement-funding decisions are not much different.

Inevitable Political Pressure

But, in the end, the main threat from government investing in the stock market is the inevitable political pressure that will be brought to bear. For that reason, Professor Romano, after her extensive study, recommended transferring control of state-employee pension assets from public boards to individual employees in order to reduce, if not eliminate, "the opportunity to apply damaging political pressure on decisions concerning those assets."

Alan Greenspan goes farther. He worries that a system of government investing would "have far-reaching potential dangers for a free American economy and a free American society."

For the government to use tax dollars to buy shares of private American corporations is for this country to take a giant step in precisely the wrong direction. It is also unnecessary. If higher returns on retirement contributions are needed—and they are—individuals are fully capable of seeking them in a system that replaces part or all of Social Security with private investment accounts that Americans would own themselves.

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

Mr. OXLEY. Thanks to all of the panel, and we appreciate your testifying.

Let me begin with a round of questions. In a general sense, when Social Security was first enacted back in the 1930's, Social Security was essentially meant as a supplement to one's retirement and that it would be a piece of one's retirement but not all of it.

Over the years, in your estimation has that changed? Are we now as Americans considering Social Security as the bedrock of retirement? And if that is indeed the case, what are the implications for that on the basis of the yawning chasm of deficits in the Social Security system, Mr. Reischauer?

Mr. REISCHAUER. Mr. Chairman, let me just talk a bit about the history. When Social Security was enacted in 1935, a tiny minority of American workers had pension plans from their employer. The major sources of retirement income were personal savings and extended family support. And so Social Security really was awful large.

In ensuing years, we have articulated the notion of the three-legged stool, that Social Security should be one component of a retirement income that consisted of an employer-sponsored pension and private savings. It is, however, an unfortunate fact that only about half of American workers are covered by employer-sponsored retirement plans. So many are left with just Social Security and whatever they can put away in an IRA or in non- tax-favored saving vehicles.

We should do, I think, everything we can to encourage employers to provide pension plans, and there were several pieces of legislation which Congress has been working on to do this, to simplify and lower the costs of such pension plans for small employers who are the primary problem here, and do things to encourage individuals to save in the way the President's USA account would do.

Over the course of this period, Americans have relied less on Social Security than they did in the past, but at the same time, 17 percent of retirees have no other means of income besides Social Security, and it provides over half of the income for two-thirds of the retirees.

Mr. OXLEY. Have those numbers remained relatively constant?

Mr. REISCHAUER. The fraction of the population with a private pension plan has not changed much for the last decade, unfortunately. I would expect the fraction—but the fraction of retiree income coming from pension plans actually has been increased, no small measure because of the benefits brought by ERISA.

Many were covered by pension plans in the 1950's and 1960's, but never received benefits because they were eased out of a job or their company went bankrupt before they got to that golden period. And by changing investment requirements, law approvals, we really have greatly improved that situation, so the fraction of the retired population with pensions has been increasing and the aggregate dollar level of their benefits has been increasing quite rapidly as well—which, by the way, is one of the unexpected reasons—one of the reasons for the unexpected growth in revenues that we have enjoyed that has helped us develop these surpluses.

Mr. OXLEY. Mr. John?

Mr. JOHN. Well, I agree as far as proportion and who is covered. There is also a question of what income level is covered. If you look at the 45 to 50 percent of American workers who are covered by a private pension plan, it tends to be the upper income group. Likewise, if you look at savings, your average American family has about $1,000 in liquid assets that they can live on, which is fine if you are planning on living 2 weeks after you retire. I personally hope to live a little bit longer than that.

When it comes down to it, for your average working American Social Security ends up being the predominant portion of their pension plan. And, unfortunately, as you pointed out in the rate or return discussions, these are the people who are, unfortunately, being hurt the most, because they have the lowest rate of return.

If you look at someone who had a 401(k) over the last 12 months, if they went into the S&P 500 they went up 23.3 percent. If they went into the Nasdaq, it was 36 percent, corporate bonds 6.4 percent. Even the Series I savings bond was up 5 percent. Well, when it comes down to it, your average family is 1.2 percent rate of return, and a minority family, in particular a low-income African-American family, you actually go into the negatives, very seriously to the negatives.

Mr. OXLEY. Mr. Glassman?

Mr. GLASSMAN. I really think that what is most shameful, in fact, about the Social Security system is that it deprives low-income Americans of the opportunity to participate in the stock market.

Over the last 16 years the Dow has gone from under 800 to over 9,000, but the people who have benefited from this have tended to be upper-middle- and upper-income people, because as Congressman Sanford said earlier, low-income Americans do not have the savings to put into the stock market. And under the President's plan, it is doubtful that they will be able to participate to anywhere near the degree that they would under a private account system.

So, really, we really need somehow, and I think there are lots of plans on the table, to get lower-income Americans to be able to invest for the long term in a safe way, their money in the stock market.

Mr. OXLEY. Thank you.

Mr. Greenwood?

Mr. GREENWOOD. Thank you, Mr. Chairman. What is the standard to rethink if we have a proposal by—to what extent do we in increased consideration of the impact of government savings on the stock market, and is that appropriate or is it not?

Mr. GLASSMAN. Well, Congressman, I think that in a general sense you probably already do that. I mean, probably in the back of your minds at least is the idea that, well, we do not want to take unwise steps that might hurt the economy and therefore hurt the stock market.

My main concern is ownership of individual stocks. For example, if the government owns $9 billion worth of stock in Philip Morris, will that then make you hesitate about enacting laws that might be harmful to that company that you own 1 percent of? And even if there is some kind of insulation as far as ownership is concerned, you might be concerned that the Social Security trust fund would be affected, or it would be affected by your ownership of Microsoft.

So I am more worried about individual stocks than about what steps you might take that would—I mean, concerns that you might have about hurting the stock market as a whole.

Mr. JOHN. As a former staffer, let me answer that in slightly different way. Suppose we put the Social Security trust fund in the stock market, and the Wall Street Journal has a little piece at the bottom of one of the pages that tells you what the value of the Social Security trust fund is today and what it was yesterday.

Now, I vaguely remember floods of letters any time there was any discussion of a reduction in the value of the Social Security trust fund, would it be able to meet all requirements, et cetera. If you have got a number that is in there, I would suggest that you are going to raise anxiety to a certain level.

Mr. REISCHAUER. Let me agree with Jim Glassman for a rare time, and say that the stock market is a reflection of the future strength of our Nation's economy, and you as policymakers are concerned about the ongoing health of our economy and are doing everything you can to strengthen that future.

We are looking—from this discussion, it sounds like Social Security is a day tripper, that we are worried about what preserves the worth today versus 2 days from now.

This is an investment for a lifetime. It is probably very unlikely that the trust fund balance, given the demography that we project, is ever actually going to be run down.

You are looking at affording a 75-year horizon here. There will be no need to put in the newspaper what the trust fund is worth. There is no reason to look at the value of the trust fund on a daily basis with it invested in bonds, either.

I would just like to make one comment about some of the numbers that Mr. Glassman has been using, and he said he was concerned about owning $9 billion worth of Microsoft or a particular company. That is not the right way to look at it. The way to look at it is, what fraction of the portfolio of Social Security is going to be in that stock, and the answer is a tiny fraction. A fraction that is representative of its percentage in the total valuation of stocks in the country. And $9 billion might sound like a lot of money to those of us looking at it one way, but looking at it in the context of all of the stocks owned by the trust fund, it is not particularly relevant.

Just to be fair, let me take a swipe at Mr. John as well, who keeps comparing the return on Social Security, 1.2 percent, with the returns one could get from the Nasdaq last year or something. Of course, one would want a longer period than that, and I am sure he would agree.

But what these comparisons are doing or suggesting really are incorrect. The trust fund reserves last year did not make 1.2 percent. They made a return of a little over 5 percent, I believe, and that is the correct comparison. What did the Treasury pay on the reserves?

The return to Social Security participants is affected by the fact that three out of four dollars that we send into this system goes to pay for our parents, our grandparents, our great uncle's benefits. Somebody is going to have to pay for those. If we take the money out of the system now and put it in Mr. Glassman's private account, we are going to have to raise taxes somewhere else to pay for our grandparents and parents, or else they are going to be living with us.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from Arizona, Mr. Shadegg.

Mr. SHADEGG. What is the disadvantage of having that through tighter control? There has been some pretty good discussion about government investing, so tell me what you see as a disadvantage for this?

Mr. REISCHAUER. Well, then we are really comparing two very different systems, and we would want to look at a lot of other dimensions. We are comparing something that is probably a hybrid defined benefit, defined contribution system with a defined benefit system. And to the extent we move to private accounts, risk would be shifted from society, which bears the risk under defined benefit programs, in part to individuals. And their benefit would be uncertain, the portion of it that came from their private account.

To the extent we move to individual accounts, we would also have to change our notion of social assistance, which is provided by Social Security. This is a program which provides, in a sense, extra benefits for those who have low wages during their lives, those who have not participated in paid employment and are spouses of somebody who did, those who have been married for 10 years and divorced, and these are redistributions that take place within our system now and are terribly important to keeping people out of poverty in their old age that would not be possible to the extent that we relied on individual accounts.

Mr. SHADEGG. This blend is a mixture of the current system plus partially funded individual accounts.

Mr. Glassman, perhaps you could respond to that.

Mr. GLASSMAN. Well, let me just comment on this concept of risk.

Somehow the advocates of government investing in the stock market have this idea that government investing in the stock market is somehow less risky than individual. The risk exists. It does not matter who invests in the stock market, whether it is you or me or the government. It is exactly the same.

Mr. REISCHAUER. And I agree with Mr. Glassman for a second time today.

Mr. GLASSMAN. Come on, Bob. We agree many times, don't we?

But it is true that the government could, through the taxing power—the government has the resources to back up individuals or its own investments, but it has that, anyway. It does not matter who is making the investment.

Mr. SHADEGG. And that is contemplated in any system that authorizes private investment?

Mr. GLASSMAN. I myself am a little bit worried about a direct insurance program because I think that leads to riskier investing. It sort of creates a moral hazard problem, but, certainly, we know politically there would be that safety net. You could go to a system such as what you just described, where it is a partial privatization where there would be a floor that might be lower than the floor—it would certainly be lower than Social Security now, but it would provide that safety net.

So can I use 1 second of my time to respond to my good friend, Mr. Reischauer?

As far as the proportion of the portfolio that Microsoft would represent, it is a big number. If you used the S&P 500 index, it would be 3.5 percent of the portfolio, and not $9 billion. By the year 2014, it would be $32 billion.

So we are not talking about small sums here, and even if you used the Wilshire index, it would be over 2 percent. So these are not small sums or small investments in individual American companies. That is my only point.

Mr. SHADEGG. My last question for you, all panel members: I understand what you mean by people at a lower income level not participating in the market and therefore not being able to take advantage of the growth of this economy.

I happen to believe that if you create a system which includes the ability for at least some people at the younger age begin to put money aside in the private account, it could have the dynamic that is not actually discussed. It would illustrate to those people that the market really does work.

Has that factored in?

Mr. GLASSMAN. I was going to say, this has been the experience in Chile at least, which has had this kind of system since 1981.

Mr. JOHN. It has also been the experience in the United Kingdom and to an extent in the experience in Australia.

Mr. REISCHAUER. I have a question to these two gentlemen, which is I thought the question was, is there an indication that by providing private investment through the mandatory pension system, low-wage workers or median-income families have gotten a taste for investment and increased their saving. I am not aware of any study that suggested that is the case in Chile or in Australia.

Mr. SHADEGG. That is in fact my question, and what my other question would be, since two of you did say yes, there is evidence to that effect, could you submit it to the committee?

Mr. GLASSMAN. Yes, I would be happy to.

Mr. GILLMOR. The gentleman's time has expired.

The gentleman from Massachusetts, Mr. Markey?

Mr. MARKEY. Thank you, Mr. Chairman, very much.

As I mentioned earlier in my opening statement, Mr. Bartlett and Mr. Pomeroy are going to introduce a bill later on today to insulate the investment fund that could be created under the President's proposal from political interference.

Let me just go down what we are going to propose in order to deal with the problem.

One, we establish an independent agency to oversee the investment, governed by a board, appointed for 10 years, staggered terms.

Two, we ban the board or the executive director of the fund from doing any individual stock picking.

Three, we ban them from picking any stock index of a fund based on the political, social or religious considerations, and we direct them to instead focus on maximizing returns and minimizing administrative costs.

Four, we require that the actual investing be done by professional money managers.

Five, we limit any one money manager to controlling 1 percent or less of any of the total common stock of a company on the index, so that the many managers that would be selected would have independent investing authority and not anyone with more than 1-percent control of any company.

Six, we direct that the managers mirror-vote their shares in the same percentage as all of the other shares are voted, so that the fund remains neutral in any corporate governance matter.

So, if the vote is 51 to 49 by all of the shareholders, that is how the vote has to be coming from the government-owned shares, and in that way, there is no influence whatsoever.

So let me pose this to the panel. Why wouldn't that insulate? Why wouldn't that protect against the kind of political interference you are concerned with?

Mr. Glassman?

Mr. GLASSMAN. Well, it is a law and it can be changed. If it is a constitutional amendment, it might be able to sustain objections.

What happens if there is another South Africa, as 30 States have put restrictions on government employee pension fund investments in South Africa?

I am with Chairman Greenspan on this. I just have my doubts that any fund can resist the political pressures that exist up here. You have been here for a long time. You know what kind of political pressures exist.

Let me just raise a second issue, which is this matter of index investing. Any index that you choose is an investment choice or a political choice, really. If you choose the S&P 500 you are choosing very large corporations. Even if you choose the Wilshire 5000, which is an index comprising every listed stock, 7,000 of them, that is market-cap weighted. So that is weighted toward large companies.

I am not sure exactly what kind of index you could use. Would you equally put money into all 7,000 companies? That would be a lot of money for a little tiny company. I would like to start one tomorrow. It just raises some very difficult technical issues.

If you do set up such a board and if you do believe that it could be insulated, I would give managers actually much more discretion than you would want to give them. I think it is almost impossible to simply say you can only go into index funds because those are decisions. In fact, they may be bad investment decisions. Lately, index funds have been terrific, but they might not be good in the future. I just have some doubts.

Mr. MARKEY. But if you pick the Wilshire 5000, you are capturing every firm, whether it be high tech or smoke-stacking. Everyone is in. Again, the objective of the fund would be not to pick the winners and losers in the marketplace, apart from the goal of insuring the retirees with the highest-possible return.

If there are pension capitalists or others in my district who want to invest in the hundreds of thousands of software and computer high-tech firms that are in my district, they are still free to do so. It will lift up those companies, but for the purposes of what we are trying to achieve, which is to catch that spread between the 7 percent that the little shareholder of 40 or 50 years would choose as a return as opposed to the 2.5-percent yield from the bond market, I think it deals with a political influence question and it deals with the spreading of risk. It deals with the gambling question because there will be long-term investors. We try to reduce all of the concerns which people have justifiably raised and at the same time have people be able to get the benefit of a safe and comfortable long-term investment in the market.

I understand your concern, but, again, Henry Gonzalez introduced a bill to repeal the independence of the Federal Reserve every year for 30 years, and it did not go anywhere. I suppose any one of us could introduce a bill to curb the independence of the FERS investment board, those who invest, but no one has ever done it.

If we on a collective basis agree unanimously to pass a piece of legislation to this effect, theoretically anyone could come back and undo it. I just think it would be a very difficult political act, though, to engage successfully.

Mr. GLASSMAN. Just one comment about the Federal Reserve. I think if you ask Alan Greenspan this question, he would probably admit, if he were candid, that the Federal Reserve is indeed subject to political pressures. I mean it is. He comes up here and testifies on Capitol Hill. He cannot tell you, "No, I am not going to come." I mean, obviously he and the other Governors operate—maybe these pressures are subtle, but they certainly exist.

Let me just make a point about the Wilshire. You say that you cannot have more than 1 percent in any stock, and I think that makes sense, but just off the top of my head, Microsoft, which is the largest company in the Wilshire, I am almost positive represents somewhere between 2 and 2.5 percent of that index.

So that is the kind of problem—I do not want to be too technical, but I think that is the kind of problem you get into.

Mr. REISCHAUER. Well, weren't you suggesting that no fund manager could go with more than 1 percent? So, if you have six or seven fund managers, it would allow you to have 6 or 7 percent.

Mr. GLASSMAN. Well, do you think that 6 or 7——

Mr. MARKEY. The board would hire Vanguarg and Fidelity and five other fund managers, but none of them could invest more than 1 percent, although the cumulative goal could be more than 1 percent in any individual company.

Again, if the concern was the political influence that the one manager could have, we would remove that down to no more than 1 percent, although the retirees would get the benefit of the widest possible investment strategy.

Yes, sir.

Mr. JOHN. Just a couple of very quick points, if I may. One is you say that the government would vote according to the rest of the stockholders with that. How do you know that in advance? I mean, essentially, what you are doing is not voting those shares.

Mr. MARKEY. We would send instructions to the transfer agent to vote in the same percentage as the other——

Mr. JOHN. So they would not vote until after the rest of the votes were announced.

Now, No. 2 is that if you are developing your own stock index here, which hypothetically you could be, I could develop a stock index and give you a wonderful reason for doing it that did not invest in any companies that included tobacco stocks, liquor manufacturers, nuclear powerplants or anyone who gave to the Democratic National Committee in the last year. All of that is hypothetically possible.

I just point out that in 1974, Congress once and for all took care of any political influence problems in the campaign finance laws, and at that point, it developed what was seemingly a seamless situation.

Mr. MARKEY. Like I said, Mr. Bartlett has a zero ADA rating and I have a 100-percent ADA rating. We are agreeing to agree that we can find all the words that are necessary to make it clear in the language of the legislation that we are talking about, generally recognized indexes and not some subset that might be created.

Mr. GILLMOR. The gentleman's time has expired.

The gentleman from California, Mr. Cox?

Mr. COX. Thank you, Mr. Chairman.

I am very interested in the legislative proposal advanced by my colleague, Mr. Markey, and other colleagues in Congress. It causes us to address the question of whether the Federal Government should invest in the stock market is a good idea or not. We ought to ask ourselves, it seems to me, why we are here and why Social Security needs fixing.

We are here because the so-called trust fund, the Social Security trust fund is invested exclusively in government liabilities. It is a wonderful thing to have a Treasury fund. You are not in the Federal Government, but the one person—there is a fundamental distinction between a liability and asset that we are missing here. The reason we are here today is that rather than put real assets behind the Social Security system and set up on a pay-as-you-go basis, demographics made that work marvelously well throughout the 20th century. Demographics are not going to make that work. That is why we are told by the Social Security that if we do not do something fast, the 35-year-old worker is going to have to pay 18-percent higher payroll taxes or have his benefits cut by 25 percent.

Government did not do what government promised. That is our problem. So the question is how much government control do we want in these investments. What would be the fundamental problem with investing in index funds if the Federal Government did control it? How does the individual screw that up?

I checked Mr. Reischauer's report, and I found out that the problem is not that people cannot be trusted to invest in index funds, but, rather, that there would then be political pressure on Congress to change the law so that they could control the accounts, so they could take their money out sooner. That same political pressure could be used on Congress to change this law or to change any law or to change the current laws that we have, which would say it is all insulated from political involvement.

I just want to know, Mr. Glassman, you said that it might be sensible to have the Federal Government own U.S.—in truth, whatever he is talking about is buying a fractional of ownership, not even the 5 percent of the SEC that has control.

So isn't it true that what we are really talking about here is not socialism, but fascism, that it is private property for government purposes, that private property at the government direction, private property used for government purposes?

Mr. GLASSMAN. Well, let me duck question.

I think that if that is your characterization, you and I agree on many things. So I have to think about that, though, but I do believe that you have to begin with first principles. I think the question, whether it is index funds or not index funds, that is later on.

The first question you have got to ask yourself is, is it proper, is it within this country's tradition, does it fit in the way the rest of the world is moving, for us to take payroll taxes, for the government to invest payroll taxes in the stock market?

I just cannot stress enough the profound change that this represents in the role of the U.S. Government, and whether you call it socialism or fascism or whatever it is, it does not seem to me to comport very well with American traditions, and I think constitutional traditions.

We have always separated as much as we could the government from the private sector, and the government will become a major owner of American corporations.

I mean anyone who does not think 3 percent stockholding is a lot, look at what Calpers did to General Motors, okay? Maybe they did the right thing, but this is the power that can be wielded by a stockholder of only 2 or 3 percent in a large corporation.

Mr. OXLEY. The gentleman's time has expired.

Mr. Shimkus?

Mr. SHIMKUS. Thank you, Mr. Chairman.

The terminology is very important. I am not a lawyer. So I am not an expert in the legal aspects of the language, but it is not correct to say rate of return on Social Security today. Rate of return would assume that there is an account by which you can then calculate—there is a principal and then there is the interest amount, and then you would calculate it.

Today's Social Security is a tax which has promised entitlements which the courts have ruled may not be paid. Is that correct? Am I talking the proper English here?

Mr. JOHN. Actually, you are correct, but what you can do to approximate that is to measure all of the taxes that are paid as opposed to all of the returns that on the average an individual can expect.

Mr. SHIMKUS. I understand that, but the problem with that is we continue to deceive the public by doing that.

We continue to state to the public that there is a rate of return on their investment, and that they have something there, when in reality what they are is paying taxes to the current recipients in the hopes of having future taxpayers pay down the sum amount in retirement.

Mr. JOHN. To an extent, I agree with you, and one of the things that has not been discussed to any great extent is that if future taxes only brings in enough to pay 72 percent of benefits, which is what is projected by the Social Security Administration, then these are very high-risk activities.

The one advantage that you do have with a rate of return is that it allows you to compare opportunity costs; in other words, what could you do with that money.

Roughly three-quarters of the American people, their highest tax is Social Security tax in one form or another, and what we have tried to do by using rate of return is to point out to them that they could do better under a slightly different structure.

Mr. SHIMKUS. Let me address the President's proposal, and, Mr. John, if you could answer first.

It is my understanding in the President's proposal of investing and receiving returns that the question is that the incoming payroll tax receipts will fall short of the outgoing Social Security benefits in 2013.

Does the President's reform proposal for saving Social Security make any reforms to address the upcoming 2013 shortfall?

Mr. JOHN. According to the new Comptroller General, David Walker, no, it does not.

Mr. GLASSMAN. I agree with that. It does not.

When you get to the year 2013, there will be a whole bunch of bonds left in the trust fund, and giving people bonds, Social Security beneficiaries, to take to the grocery store to buy their groceries is not going to work very well. So those bonds have to be cashed in. So where is the money going to come from? Well, it can only come from either tax revenues or through further debt.

What the administration is saying is by kind of paying down some of the debt or by getting some revenues from investment in the stock market, it will be easier to borrow the money down the road if we need to borrow it, but the cash will not be there, is the answer.

Mr. REISCHAUER. Well, let me just disagree with the two of them, and that is that there is a small difference. That is, the equity investment would create a flow of revenues into the trust fund that would boost revenues and add maybe a little bit to that time.

Mr. SHIMKUS. You are referring to a year or two versus the real plan is to move the chart or actually move the 2035 date to, what, 2075 or to push it. The outlays are still going to occur within the 2013 framework. There is no real addressing the inherent——

Mr. REISCHAUER. But to be fair to the President, he did not suggest this was the whole enchilada. He said what I am doing is presenting one piece of a larger package. Now, he has not come forth with the remaining piece of that package, and I think you can say, "Next move, Mr. President." but this was not intended to be the whole story.

Mr. JOHN. There is another problem with this, which is even if you buy the President's assumptions, suppose you subtract out the OMB deficit projections and you put in the CBO deficit projections. What you come up with is a fact, again leaving everything else the same, that you have spent several trillion dollars and hypothetically you have bought 8 years, as opposed to moving to substantially more than that. That includes government investment, and when you subtract out government investment, that buys precisely 2 years.

Mr. OXLEY. The gentleman's time has expired, and I thank you.

The gentleman from Pennsylvania, Mr. Greenwood?

Mr. GREENWOOD. Mr. Chairman, I would like to begin with Mr. Reischauer, and the others may respond as well.

I apologize for not being here during your testimony, but I have read your testimonies.

Looking at the critical job that you did in terms of describing how a series of firewalls could be built, I will call them firewalls, in order to insulate these investments from political influence, it is credible, but it is also credible, looking at these examples.

I would just like each of you to respond to how fireproof these firewalls really would be.

Mr. REISCHAUER. Having worked up here for over 12 years, I certainly defer to your judgment on the potential for this body to foment mischief in this area, but I think we are really getting ourselves overly worked up over this issue.

The principle of hands-off the environment, I think, would be established in the debate, and would be supported. I have no doubt that individual members will stand up from time to time and say Levi Strauss has closed a factory in my area and moved jobs offshore. I think that we should remove that from Social Security investment, but a lot of that would be more for posturing purposes than for actual meaningful legislative action.

I think there would be a constituency on the other side, a constituency that would be very strong among the aged and among workers that would say, politics, stay out of this. I do not agree with everything, with all of the investments, but that is not the way this thing was set up.

I could be wrong. Jim would argue that my judgment here is naive, but I think——

Mr. GREENWOOD. If I may interrupt, and I apologize for doing that, the argument that you have made, that has not been the experience with Thrift Savings and other funds. It is a persuasive argument, and I think the question would be the order of magnitude and visibility of this fund to change.

Mr. REISCHAUER. I think that works both ways on both sides. There is a big constituency of regular Americans who just say you stay out of this, which maybe is not the case when you are dealing with State employees, all of whom are unionized.

Mr. GLASSMAN. I just want to respond to the Thrift Savings Plan issue, which is addressed in my written statement.

Advocates bring this plan up all the time, saying you have this insulation. The Thrift Savings Plan is a completely different animal from what we are talking about here.

It is a defined contribution plan, which means that the employees themselves, Federal employees themselves, direct where their savings will go, and they actually own the account. The government is just a fiduciary.

I do not want to read the whole thing, but in the conference report in 1986, when the Thrift Savings Plan was set up, this issue was addressed, and the observation was made that it is in the inherent nature of a defined contribution plan and that you do not tamper with it. That is why it was set up as a defined contribution plan. As I said, it is in my statement. I really think that that distinction should be made.

I would also say, and I do not know whether Mr. Reischauer would agree with me, but the Thrift Savings Plan actually makes a very nice foundation for a system of moving toward private accounts.

With the Thrift Savings Plan, you get to choose yourself where you are going to put the money. The government does not make the choices. It is your money. You choose. This is the way the 401(k) plans work.

The fact that the government has stayed out is natural in a situation where individuals own accounts. Individuals will not stand for this, and that is why I think that is the direction we should move in rather than toward what the President proposes.

Mr. JOHN. I would like to agree with that, actually, and completely, but just to point out that a couple days after the President's plan was announced, there was a hearing in the Ways and Means Committee where Reverend Jesse Jackson announced that he thought that it was a fine idea for the government to invest in private-sector items as long as it did not have anything to do with tobacco, guns or liquor.

Now, within the last few weeks, we have had a number of reports. The AFL-CIO has been sending out letters to everyone who invests in their pension plans, saying that in the event that you publicly take a position in support of any form of privatization of Social Security, we are going to pull our money. They also announced at their convention down in Florida about a week ago that they are going to be monitoring how their pension managers vote on AFL-CIO resolutions. Now, here is a quick case of where the pension needs of their members are being subordinated to short-term political goals.

Mr. OXLEY. The gentleman's time has expired.

Did you have something, Mr. Reischauer?

Mr. REISCHAUER. I just have a footnote on Mr. Glassman's answer, and it is that the defined contribution, the TSP-type framework, does not get around this question completely because what we do for Federal workers is we present them with three options, and the question is who defines those options.

Well, you could have a situation in which the Congress said one of the options will be, as it is now, the Standard & Poor's 500, less Levi Strauss, Microsoft, Philip Morris, whatever is objectionable. So, unless you allow a broad selection of investment alternatives, you still have this problem, not to the same degree maybe, but you still have it.

If you go to a broad set of investment options, you then have a problem of administrative cost and compliance, and these things are all interwoven with each other and it makes it very difficult.

Mr. GLASSMAN. Right. Can I just say I agree with that analysis. It certainly is possible the Congress could pass a law that would interfere with individual ownership.

In fact, you could pass a law right now to stop all Americans from investing their own money in Philip Morris if it wanted to, I suppose. That would probably go through the courts and might be overturned, but let me just read from the conference report.

It says: "This arrangement confers upon the employee, property and other legal rights of the contributions and 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 an entity, including Congress."

Now, maybe the conference report is a little strong. It says "cannot be tampered with." It probably could be, but the chances that it would be, I think, are a great deal less than the chances that what the President has proposed will be tampered with. That is all.

Mr. OXLEY. Mr. Markey?

Mr. MARKEY. Thank you, Mr. Chairman.

Mr. Glassman, first of all, I want to say thank you for helping in our time of need.

Mr. GLASSMAN. Thank you, Congressman.

Mr. MARKEY. In the beginning of the statement, you say that Congress must answer this question, should the Federal Government have an ownership stake in private corporations. You say by no means, but this is an issue of first principles that all members must answer for themselves.

My question is, does Calpers, does the Massachusetts Teachers Retirement Fund—does that raise the same first principle question in terms of being stakeholders in the market, and should we reconsider whether or not we want States investing in the private market as a matter of course? How would you stand on that?

Mr. GLASSMAN. Well, I think State employee pension plans, and I stress employee, are a completely different kind of situation.

There is no State that I am aware of that gives pensions to its citizens on a broad-based basis the way the Social Security does. These are State employee pension plans, and I think that makes it completely different.

You have a State employee who is voluntarily deciding, okay, I will accept employment from the State under these conditions. And the State, it is true, this is State money, it is payroll tax dollars, but I think there is a pretty clear distinction between State employee pension plans and Social Security, which is essentially a universal and a mandatory, by the way, pension plan. That is all.

Mr. MARKEY. But it still does have that State element.

Mr. GLASSMAN. I agree, I agree. I have to say, I do not think these things are clear-cut, and my own opinion is that it is fine to have State employee pension plans, although I agree with Roberta Romano who studied these, Roberta Romano from Yale Law School, who studied all 50 pension plans and concluded—I do not have it here, but she concluded in fact that because there is so much political interference in these plans that they should become defined contribution plans.

Mr. MARKEY. Is that in your submission as well?

Mr. GLASSMAN. Yes, it is.

Mr. MARKEY. You have a sample?

Mr. GLASSMAN. Yes.

Mr. MARKEY. Then let's move to the other issue. If we do move it over to a system where we have individual accounts and we subtract sort of a percentage of the contribution now to that trust fund and give it back to individuals, how do we handle the issue of the present-day retired pool, plus those who are approaching that age, in terms of the guarantee of the benefit which they are now entitled to? Is this a required tax increase? How do we deal with that transitional period?

Mr. GLASSMAN. Well, first of all, I think Congress should pass a law that simply says that all persons who currently receive Social Security benefits will continue to receive those benefits at the current rate for the rest of their lives, as well perhaps as people in their fifties or are 55.

I think it is very important to put those people's minds at rest. It is really unfair for them to be worried about the discussions that are going on here, because these are discussions really about people in their twenties, thirties, and forties, not about people who are currently retired or about to become retired.

Those people should be taken care of by whatever means necessary, and if that includes a tax increase, then it will include a tax increase. I am not against that, although I am not sure that it is necessary.

Some people say it will, some people say it will not, but if it means a 1-percent or 2-percent increases in payroll taxes, I think that is a small price to pay for the increased returns that individuals have, the increased responsibility that they will gain from investing in the stock market, and frankly for the increased kind of personal freedom that they will gain in making their own decisions about their own livelihoods, just as they do in most other areas, like buying a house or having children.

These are just not the realm of government in my opinion.

Mr. MARKEY. Could I ask Mr. Reischauer on the issue of whether or not a tax increase will it be required?

Mr. REISCHAUER. Well, the answer is in the details of the plan, and most of the plans that have been put forward either require borrowing, large amounts of borrowing from the public or a tax increase or they use, at least for a time, the projected surpluses which will buildup and then have to make a decision on whether to borrow or increase taxes.

Mr. MARKEY. Would this be trying to avoid a tax increase or a borrowing?

Mr. JOHN. Well, hypothetically we examined it, and there are about four different ways that you can fill the hole when it comes right down to it.

You can use the surplus, where the alternative would be tax money. You can hypothetically reduce spending on other programs. You can sell government assets, or you can borrow money.

Now, the problem that you are going to face is that starting in 2013, no matter what, you have got a significant gap that you have got to deal with. So the question is, are you going to deal with the current gap or are you going to deal with the future gap, and which one is larger.

Now, one of the things that we did a little research on is that hypothetically you could come up with say a 2-percent carve-out or something along that line, which would substantially reduce your long-term liability.

Mr. MARKEY. Thank you, sir.

Mr. OXLEY. The gentleman's time has expired.

Let me wrap this up. First of all, thank all of you for informing us on this difficult issue.

Mr. Glassman, I read your testimony last night and agreed with almost all of it, but I wanted to know particularly from you or Mr. John, if you were to advise us as to how to best set up an individual retirement system out of Social Security or supplement Social Security as well, how would you go about it?

Some have suggested that the Federal employee retirement system is a good place to start because, as you indicated, Mr. Glassman, it is privately held, relatively low fees, and you get a choice of risk within a fairly narrow parameter. You go everywhere from a C-fund which is the biggest risk, down to the G fund, the government securities.

Is that a good place to start as we try to practice alternatives? If it is not, what would be more appropriate?

Mr. GLASSMAN. Well, I think that is a good place to start.

I think that the Thrift Savings Plan actually does a disservice to the people who are in it now because it does not give them enough alternatives. Now, I understand they are going to have a SmallCap fund and so forth. There really should be more than one stock fund as an alternative, but that certainly is not a bad way to do it.

I think it is important to start quickly, and start to allow people to kind of get a taste for investing in savings, especially the vast numbers of Americans who do not do it now.

Mr. OXLEY. Could I interrupt just a second?

Mr. GLASSMAN. Sure.

Mr. OXLEY. We should talk about it. It is true that we are talking about people in their twenties, thirties, and forties.

Mr. GLASSMAN. Right.

Mr. OXLEY. My son is 26. He is now an investor on the Internet, as are a lot of his contemporaries.

As least as I see it, the younger people or even some of the baby-boomers are getting to be relatively sophisticated investors. Half of the households in this country own computers.

Mr. GLASSMAN. Yes.

Mr. OXLEY. So it is kind of a generational thing, is it not?

Mr. GLASSMAN. Yes.

In general, you hear a lot of talk about day-trading and people trading on the Internet. There obviously is some of that, and that is not, in my opinion, investing. That is speculating or gambling, and not a good thing to do with your retirement dollars, but you could certainly set up a system that required mandatory contributions. You would have to keep your money in. You would not be able to make those kinds of day-trades.

As far as your question is concerned about sophistication, there is absolutely no doubt, and I see it in my own readers, that there has been increased sophistication about stock market investing over the last 10 years. Mainly, that sophistication revolves around the notion of buying good companies and holding onto them for a long time. That is what we are seeing. During the last stock market break, it was the small investors who stayed in and who bought, and the so-called professionals who bailed out.

So, yes, there is increased sophistication. There should be more increased sophistication. I agree with the chairman of the SEC, who issued some warnings about just going very quickly into stock market investing, investing part of Social Security in the stock market, and I agree with that. I think we should start small. We should have limited choices, but really bring the vast majority of Americans into the private sector. Let them partake of what is going on in this country.

Mr. OXLEY. Mr. John?

Mr. JOHN. I would agree with that.

The one slight difference I would make is that rather than having one choice—I mean the overall size of TSB at the end of the year 1997 was $60 billion or so. If you take 2 percent of the OASI funds and put them into some sort of a mandatory savings account, you are talking about something on the order of $60- to $80 billion a year, not counting buildup. At some point or another, it does make sense to start maybe with three investment options. As I say, that holds down administrative costs rather directly, but rather than saying everyone must put their money in say the Barclay's Equity Index Fund or something along that line, if I had the option to choose an index fund, as long as it had a minimum of 500 stocks or so and I could buy that regardless of whether it is from the credit union downstairs or Merrill Lynch or Goldman Sachs or Prudential Insurance Company. This would all you to spread out, and you would not have the problems of huge sums being dumped into one index bond or two index bonds or something along that line.

Mr. OXLEY. You would both agree though that an index fund is the way to go?

Mr. GLASSMAN. I think several index funds should be the way to go, different index funds, and let me also associate——

Mr. OXLEY. Do you think people should buy index funds?

Mr. GLASSMAN. Yes, absolutely, people should have the option.

Let me also just associate myself with what Mr. John just said. I think I would much prefer a system where private companies, strong private investment firms will be able to offer these investment products rather than just a few, although there is this issue of administrative costs, and that has to be resolved one way or the other.

Mr. OXLEY. Let me ask you this. A lot of people say that they are not sophisticated enough to make those kind of investments, they are likely to lose their savings, that we ought to just raise taxes. What is your reaction to those who say we ought to trust people to make these decisions that involves their family, their personal best interests?

Mr. REISCHAUER. Oh, I think we very definitely should, and we do. We give workers in American who have 401(k) plans lots of ability to make those choices. We offer IRA's and other tax-advantage savings vehicles which people can——

Mr. OXLEY. That is indeed part of the fabric.

Mr. REISCHAUER. The real question is, do you want to put all of your eggs in a single basket.

I think you are undoubtedly right when you say there is a generational shift going on, that younger generations have more sophistication and more knowledge, but let's not kid ourselves.

Look at the figures that Arthur Leavitt included in his talk up at The Kennedy School about the American people's sophistication. The vast majority do not know the difference between a stock and a bond, and we are talking about 80 or 90 percent do not know what a load is on a mutual fund. There is tremendous ignorance still out there.

Mr. Glassman mentions that there has been a tremendous surge of interest in financial market information. We have had 4 years of over 20-percent growth in the stock market. This has become something like a sport or a recreation activity.

If we were to go back to more normal returns, where it went up 15 percent, down 3, it averaged 7 or 8 over a long period of time, you might find a lot of people who seem to express a lot of interest in these issues, and I am one of them. I am an avid reader of your column every week.

There are a huge number of Americans who want this, in a sense, taken care of for them. This is the basic foundation of retirement income. It is not the whole kit and caboodle, and what we want to do is make sure we have that basic foundation secure and predictable and adjusted for inflation. It is very difficult to do those three things with the component that would be in private accounts.

Mr. OXLEY. With that, let me again thank you all for an excellent morning of testimony.

The subcommittee is now adjourned.

[Whereupon, at 12:30 p.m., the subcommittee was adjourned.]

THE MARKET IMPACT OF THE PRESIDENT'S SOCIAL SECURITY PROPOSAL

WEDNESDAY, MARCH 3, 1999

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON FINANCE AND HAZARDOUS MATERIALS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. Michael Oxley (chairman) presiding.

Members present: Representatives Oxley, Tauzin, Gillmor, Greenwood, Cox, Largent, Bilbray, Ganske, Shimkus, Wilson, Shadegg, Fossella, Ehrlich, Bliley (ex officio), Towns, Deutsch, Stupak, DeGette, Barrett, Luther, Markey, Hall, and Dingell (ex officio).

Staff present; David Cavicke, majority counsel; Linda Dallas Rich, majority counsel; Brian McCullough, professional staff; Robert Simison, legislative clerk, and Consuela Washington, minority counsel.

Mr. OXLEY. The subcommittee will come to order.

Before we begin the hearing, the Chair wishes to make a brief announcement. The Chair wishes to remind members that today's hearing marks the committee's first effort to broadcast a live audio feed over the committee's Internet site. Our staff and constituents may listen to today's proceedings simply by accessing the committee's website. I believe that this is another important step in making our proceedings more accessible to the people we serve.

The Chair is pleased to convene a second in the subcommittee's series of hearings on Social Security reform.

We are fortunate today to have before us the Chairman of the Board of Governors of the Federal Reserve System, the Honorable Alan Greenspan. Chairman Greenspan has raised concerns that go to the very heart of this subcommittee's interest in the issue of Social Security reform and the impact that government investment would have on our capital markets.

We are also honored today to be hearing testimony, addressing this issue, from the Deputy Secretary of the Treasury, the Honorable Lawrence Summers, who will be joining us later this afternoon, at 1:30 to be precise.

At the subcommittee's hearing last week, we heard a wide range of views as to the impact of government-controlled investment on the capital markets. But on some very fundamental issues, there was, and remains, strong bipartisan consensus.

There is consensus that, as a primary matter, our Social Security System is in dire need of reform. I believe there is a strong consensus against cutting benefits or raising taxes. Accordingly, there appears to be agreement that the best way to accomplish the necessary reform is to increase the return generated by the tax dollars that currently go into the Social Security Trust Fund. There even seems to be agreement that the best way to do that is to invest those dollars in the stock market.

Significantly, there appears to be a consensus that it is vital to our free capital markets that investment decisions relating to investment of Social Security dollars be protected from political pressures that would lead to reduced returns, corruption, or worse.

Robert Reischauer, Senior Fellow of the Brookings Institution, testified that he believed that, "If there were no effective way to shield trust fund investment decisions from political pressures, the advantage of higher returns that a diversified investment strategy would yield would not be worth the price that would have to be paid."

Where there appears to be a difference of opinion is on the question of whether it is possible to provide such a shield. This is the fundamental question that we will explore at today's hearing.

A number of the witnesses at last week's hearing echoed the view of Chairman Greenspan that it is not possible to insulate government decisionmakers from influencing the investment decisions made with respect to Social Security Trust Fund dollars in a plan such as that proposed by the President. Others suggested that the Federal Thrift Savings Plan and the pension plan of the Federal Reserve are evidence of the feasibility of providing such insulation. Some provided suggestions as to procedures and plans that could be put into place to ensure that political considerations could not possibly influence investment decisions. At stake is nothing less than the efficiency and success of our capital markets because their efficiency and success derive from the freedom that underpins those markets.

I believe this Congress has an historic opportunity to provide a tangible, enduring boon to the quality of life of American workers by reforming Social Security to ensure a better retirement for all. I look forward to finding and developing the areas of common ground that will enable us to create bipartisan reform that will accomplish this monumental achievement.

Mr. Chairman, I thank you for appearing before the subcommittee today. I note that the subcommittee will adjourn following the questioning of our first witness and reconvene at 1:30 for the testimony of Secretary Summers.

The Chair's time has expired and I will be pleased to yield to my good friend, the ranking member, gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. I also thank you very much for holding this hearing.

At this time I would like to yield to the gentleman from Massachusetts for a statement.

Mr. MARKEY. Thank you, Mr. Towns, very much and thank you, Mr. Chairman. I commend you for calling this second oversight hearing on the market impact of the President's Social Security proposal.

If we are going to invest a portion of the Social Security Trust Fund in the stock market, we basically have three choices. First, we could establish privately managed accounts. Second, we could create individual accounts that are centrally managed through a government-sponsored entity like the Federal Thrift Savings Plan. Third, we could maintain the defined benefit nature of the Social Security program while investing a portion of the Social Security reserves in broad index funds using a Thrift Savings Plan-like investment structure. This third approach is what the President has endorsed and what the bipartisan legislation that I have introduced with Representatives Bartlett and Pomeroy would implement.

Our bill contains six principal safeguards that will insulate the Social Security Investment Funds from the risk of political influence or social investing.

One, we establish an independent agency to oversee the investments, governed by a board appointed for 10-year staggered terms.

Two, we bar the board or the executive director of the investment fund from doing any individual stock picking or voting of shares.

Three, we bar the board—our executive director—from picking any stock index fund based on political, social, or religious considerations and direct them, instead, on maximizing returns and minimizing administrative costs.

Four, we require that the actual investing be done by professional money-managers who have substantial private assets under management.

Five, we limit any one money-manager to controlling 1 percent or less of any of the total common stock of a company that is on the indexes selected for the fund.

Six, we direct that the managers mirror vote their shares in the same percentage as all of the other shares voted so that the fund remains neutral in any corporate governance matter.

Today, we will be hearing from one of the most thoughtful and influential critics of the President's approach. I look forward to hearing from Chairman Greenspan on this issue. There is no one whom I respect more. I look forward, as well, to hearing from Secretary Summer this afternoon.

But, as we debate the merits of this proposal, I am reminded of something that my mother always said to me, which was that the most important question to answer in every single instance in life is, compared to what? So, let's take a look at the privately managed private account alternative.

The French have a saying that when you want to get to the bottom of any mystery, "Cherchez la femme." Here, if I want to find out what is really driving interest in private accounts, you simply need to ask, "Cherchez la fee."

You don't have to search very long here to discover that the fees associated with privately managed individual accounts are quite substantial, consuming 20 percent of the funds in an account over the coarse of a 40-year work career and an additional 10 to 15 percent in converting that individual account into an annuity. That is billions of dollars that could have supported the retirement of Main

Street instead of supporting vacation homes for Wall Street brokers.

And, what of the government-managed private account options? The basic structure and governance of such a program would be similar to the Bartlett-Markey bill. You would still face the risks of political interference in corporate governance matters or social investments. The aggregate size of the investments being made would be about the same, and you would still have to face the cost and complications of converting these accounts to annuities.

What other additional political risks might such private account schemes face? When Congress originally created IRAs, they were to be used only for retirement savings, but now IRA funds can be diverted to purchase a home or to pay educational expenses. Will we be any more successful in insulating Social Security private accounts from the inevitable political pressures to make these fund available for similar purposes?

Moreover, if there is a recession, will Congress be able to withstand the demands from the public that they be allowed to withdraw funds from the individual accounts to alleviate their immediate economic distress? And, what happens to those individual accounts when their beneficiaries reach retirement age? Will we mandate their conversion into annuities? If so, what happens to those who gamble away their savings with bad investments, simply have the bad fortune to retire during a sustained bear market?

For such individuals, converting one's recently depleted investment account into a annuity, would condemn the retiree to receive a substantially smaller monthly annuity check than those who had the good fortune to retire and annuitize during boom times. Will we be facing new generations of stock market notch babies, demanding that Congress make them whole because they were forced to invest during bad stock market times?

Mr. Chairman, when we begin to examine the consequences of these alternatives, I believe that, ultimately, we have to return to the President's approach because it gives that guarantee which is going to be so necessary for all of the retirees in our country.

I thank you. I know you gave me an extra minute or so, and I appreciate it very much. I yield back my time.

Mr. OXLEY. The gentleman's time has expired.

The Chair now recognizes the gentleman from Virginia, the chairman of the full Commerce Committee.

Chairman BLILEY. Thank you, Mr. Chairman.

Today, we will continue with our examination of the market impact of the President's Social Security proposal. Solvency of the Social Security System is vitally important. And, I commend the President by beginning the debate by coming forward with a proposal to deal with the impending problem of Social Security.

A number of estimates by the CBO and the bipartisan Task Force on Social Security indicated that, absent reform, Social Security will begin paying out more than it takes in sometime around 2013. Obviously, the earlier we deal with the structural issues causing this problem, the easier it will be to fix them.

The President has recognized that the budget surpluses we have worked so hard to produce in the last Congress, the surplus from current workers now paying into the Social Security System, gives us an opportunity to work to save Social Security and improve the retirement of all Americans.

The President has also recognized, as did the members of the Advisory Council on Social Security, that there is a role for investment in the stock market as part of any reform of Social Security. Simply put, the rate of return to investors in the stock market has been about 13 percent a year over the past 40 years. This return is much more attractive than the anemic, or sometimes negative, returns that participants in Social Security receive from their contributions.

If the return from the market can be extended to all Americans we can substantially improve the lives of Americans as they retire. I believe that this committee, which has historically looked to promote capital formation, will play an important role in protecting investors and insuring that increased market participation by Americans will be safe and fair.

There are four basic principles that I will use to evaluate any Social Security proposal.

First, there can be no diminution of benefits to current retirees. We have made an agreement with millions of Americans who depend on Social Security, and we must keep it.

Second, any changes to the Social Security System that involve private investment should be completely voluntary. If a person doesn't want to participate, he or she should be able to stay in Social Security as it currently exists.

Third, any system of private investment must have appropriate safeguards. We are not going to have Social Security money put in risky derivatives, cattle futures or other speculative instruments.

Fourth, any Social Security reform must increase the rate of return to the participants. I understand that for many young people the expected return for their lifelong contributions will be negative; for others, less than a paltry 1 percent per year. People can do better in passbook savings accounts. We should look to find a way for the benefits of the market to be shared, prudentially, with all Americans.

The committee will be active in the area of Social Security reform. We will work to improve the retirement of all Americans and see that any private investment is done safely.

I am pleased today to welcome Federal Reserve Chairman Alan Greenspan, and I look forward to hearing his views on the President's Social Security proposal and how it could affect the United States equity markets. I would also like to extend a welcome to Deputy Secretary Lawrence Summers who will be testifying before the subcommittee later this afternoon.

Mr. Chairman, I applaud your efforts for holding these ever so important hearings concerning the future of Social Security and yield back the balance of my time.

Mr. OXLEY. The gentleman yields back. The Chair now recognizes the gentleman from New York, Mr. Towns.

Mr. TOWNS. Mr. Chairman, I would like to, at this point, recognize the ranking member of the full committee, John Dingell from Michigan.

Mr. DINGELL. Mr. Chairman, I want to thank my good friend from New York and I want to thank you. Mr. Towns. It was an act of great courtesy and I thank you.

Mr. Chairman, I commend you for these hearings. I believe that it is important that we should go into this question. The President has indicated that his approach is going to produce higher rates of return for Social Security and ultimately for retirees. The proposal raises a number of concerns relative to government involvement in the stock market and in corporate governance that need to be examined and addressed if the Congress is to go down that path.

This committee has long jurisdiction and long experience in the securities market. It is imperative that this committee make this inquiry and begin the debate sooner rather than later.

I want to say a word of welcome to my very special friend, Mr. Greenspan, and tell him how delighted we are to have him here this morning and look forward to the benefit of his help and his wisdom. He has an extraordinary record of public service going far back, and it is one which he has accomplished great things for the benefit of the country. We owe him a great debt for what he has done in his great career of public service. We are also happy to welcome him here this morning because he is going to add great amounts of light and wisdom to the discussion before this committee.

The administration has not yet submitted a legislative proposal. My good friends and colleagues, Mr. Markey, Mr. Barlett, and Mr. Pomeroy, have introduced a bill, H.R. 871, to effectuate the President's plan and to establish safeguards to meet the objections and concerns that have been raised. This bill deserves serious consideration.

Mr. Chairman and my colleagues, I am willing to be educated on this matter, but I must note that I am leery of privatization of Social Security. Much of the discussion of that topic so far, especially the concept of scrapping the present system for Social Security protection in favor of individual savings accounts, seems to me to have a number of major problems, the first of which is the stock market is not a guaranteed up escalator or elevator which is going to take us all to great economic success. And, not everyone understands how to deal with the controls or, indeed, has the means to enter into this.

One of the premises is that most Americans are well-employed middle-class persons who don't save enough. This is far from the truth. There are large numbers of households which are in the stock market through mutual funds and other investment devices, but this is not representative of large numbers of families of the working poor who are struggling to keep a roof over their heads and put food on the table and to clothe and educate their families. Saving is a luxury that many in this country cannot afford in any significant amount.

It is a testament to this society that we have established and maintained a Social Security System that spreads the risk amongst all Americans and makes sure that our senior citizens, especially the elderly poor, have a financial safety net to look forward to and to fall back upon.

I would urge all to be very careful in making significant changes in Social Security that can impair public confidence in Social Security or, indeed, put at risk persons who are dependent on that in their retirement years. I would observe that many who might appear to be afloat at this time might find that economic reverses will leadve them in a situation where they will not have the protections that they expect they will have except through Social Security.

I look forward to hearing what the witnesses will say. and also look forward to seeing the rest of the President's plan. I believe that this committee can, and should, work with the Ways and Means Committee, and others of our colleagues and committees, to see to it that we handle this matter well.

In closing, I would like to submit for the record, and ask unanimous consent so to do, a letter that I have received from the State legislators, counties, cities, and mayors, and their finance officers. This letter indicates that they disagree with comments that have been made about the performance of State and local pension plans and request that they be heard on the matter. I hope that the subcommittee will give them an opportunity to clarify the record and I do hope that, Mr. Chairman, the subcommittee will put this in the record for the benefit of all of our colleagues.

[The letter follows:]

NATIONAL CONFERENCE OF STATE LEGISLATURES; NATIONAL ASSOCIATION OF COUNTIES; NATIONAL LEAGUE OF CITIES; UNITED STATES CONFERENCE OF MAYORS; GOVERNMENT FINANCE OFFICERS ASSOCIATION; NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS; NATIONAL COUNCIL ON TEACHER RETIREMENT; NATIONAL CONFERENCE ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS

March 1, 1999.

The HONORABLE JOHN D. DINGELL
United States House of Representatives
Washington, D.C. 20515

DEAR REPRESENTATIVE DINGELL: We understand the House Commerce Subcommittee on Finance and Hazardous Materials will be holding a hearing on the direct investment component of the President's Social Security reform proposal on Wednesday, March 3, 1999. We have also been advised that State and local government pension plans may be characterized in this hearing as allowing "political interference" in their investment decisions.

We have no position on the President's proposal. However, we strongly disagree with the current comments implying we earn a lower rate of return due to alleged politicization of investment decisions and policies that focus on social factors other than the best interests of the plan participants. We strongly believe that public pension plan assets are invested in a prudent manner that ensures that plan participants receive the benefits to which they are entitled and also in a manner that reduces the costs for taxpayer support of the plans.

Should the Subcommittee find it necessary to raise the issue of the investment performance of State and local government pension plans, we respectfully request the Subcommittee invite independent experts to testify on the rates of return obtained by public pension plans as compared to their private sector counterparts over the past several years. Such testimony will show that the rates of return achieved by public and private plans over these periods are quite similar. Furthermore, it will provide the Subcommittee with information based on current data.

In his recent appearances before Congress, Federal Reserve Board Chairman Alan Greenspan has provided several committees with information on the performance of state and local investments based on information from the 1960s through the 1980s. Chairman Greenspan has suggested that this information shows the rates of return for public sector plans trailing by two to three percentage points the return rates of private sector plans. Chairman Greenspan suggests that some of the disparity might be ascribed to political interference in the management of the State or local pension plans. This is incorrect. Even the Chairman has conceded in recent discussions that that much of this disparity would be eliminated were these returns adjusted for risk in light of the fact that State and local pension funds are often invested more conservatively than private plans.

We believe virtually all of this lag is attributable to the investment restrictions imposed on public funds but not on corporate plans. As these restrictions have gradually been lifted, public funds' performances have grown to become comparable with private pension funds. *Current data shows that public retirement funds are efficiently managed financial institutions with well diversified portfolios that have achieved impressive rates of return*.

If the Subcommittee does wish to pursue the issue of State and local government pension investment practices, we would appeal for a full, fair and complete hearing record. We respectfully request that the Subcommittee invite independent experts to testify on the rates of return obtained by public pension plans as compared to their private sector counterparts over the past several years.

We would suggest that you call Laurette Bryan and/or John Gruber, Senior Vice Presidents of State Street Bank. Their testimony will be factually rooted in the actual rates of return experienced and provided by scores of the nation's public and private pension plans to their institution as well as Chase Manhattan Bank, Citiank, Mellon Bank, Northern Trust Company, U.S. Trust, Bank of New York, NationsBank and 11 other banks. These banks support the Trust Universe Comparison Service (TUCS), which produces rates of return and other data that are used as the industry standard by which pensions measure their performance. (We have attached a summary of these independent findings for your review).

We appreciate your consideration. If you have any questions or would like additional information you may contact our legislative representatives:

Gerri Madrid/Sheri Steisel, NCSL, 202/624-8670, 8693
Neil Bomberg, NACo, 202/393-6226
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Tom Owens, GFOA, 202/429-2750
Jeannine Markoe Raymond, NASRA, 202/624-1417
Cindie Moore, NCTR, 703/243-3494
Ed Braman, NCPERS, 202/429-2230

Corporate and Public Pension Plan Rates of Return

Trust Universe Comparison Service (TUCS)

A service of 19 of the nation's leading banks, including Chase Manhattan Bank, Citibank, Mellon Bank, Northern Trust Company, State Street Bank, U.S. Trust, Bank of New York and NationsBank

	Rates of Return for Periods Ending June 30, 1998				
	3-Month	1-Year	3-Year	5-Year	10-Year
Median Domestic Equity					
CORPORATE	**1.20%**	**25.82%**	**26.86%**	**20.91%**	**17.34%**
# of Funds Reporting	150	143	136	125	80
PUBLIC	**0.94%**	**25.63%**	**27.11%**	**21.20%**	**17.33%**
# of Funds Reporting	45	44	36	35	26
Public versus Corporate Fund Returns	-0.26%	-0.19%	0.25%	0.29%	-0.01%

This table shows the rates of return on only the equity or stock portions of both corporate and public funds, demonstrating that the return rates on similar investments are the same. Over the ten-year period, public funds' rate of return was only .01% less than corporate funds.

This table shows the rates of return on the entire portfolios, including equities, bonds and other investments. Note the greater percentage of assets in corporate funds allocated to equities, which are riskier. Public funds allocate less to equities in favor of bonds and other more conservative investments. Nevertheless, over the ten-year period, public funds' rate of return was only .8% less than corporate funds.

	Rates of Return for Periods Ending June 30, 1998				
	3-Month	1-Year	3-Year	5-Year	10-Year
Median Total Fund					
CORPORATE	**1.14%**	**18.25%**	**18.95%**	**15.12%**	**13.48%**
# of Funds Reporting	173	163	155	149	112
% Invested in Domestic Equities	56.70%	n/a	n/a	n/a	n/a
Total Market Value of Funds	$306.9 billion				
PUBLIC	**1.32%**	**17.60%**	**17.83%**	**14.30%**	**12.68%**
# of Funds Reporting	57	55	51	48	40
% Invested in Domestic Equities	47.20%	n/a	n/a	n/a	n/a
Total Market Value of Funds	$622.6 billion				
Public v. Corporate Funds Return Rates	0.18%	-0.65%	-1.12%	-0.82%	-0.80%

Mr. DINGELL. Again, Mr. Chairman, I thank you for this. This is a very important undertaking and it requires calm consideration, and I am sure that Mr. Greenspan will lead off well and guide us well in his presentation. I thank him for being here.

Mr. OXLEY. And, without objection, the material will be entered in the record at the request of the gentleman from Michigan.

The Chair now recognizes the vice chairman of the subcommittee, the gentleman from Louisiana, Mr. Tauzin.

Mr. TAUZIN. Thank you, Mr. Chairman, and good morning, Mr. Greenspan. I certainly want to thank you, again, and commend you, as others have, for both holding these hearings, Mr. Greenspan, for your agreeing to appear and to help us through this issue.

The President's proposal to earmark a substantial portion of the budget surplus for investment in the stock market is, obviously, conceptually a very interesting idea. Nonetheless, the prospect of the Federal Government holding an equity position in a variety of our Nation's companies raises a number of serious concerns that I hope we hear more about today.

Thus far, for example, I think we haven't heard enough about how the President's plan might affect America's capital markets and investor protection. Specifically, I am curious to know whether public investment in capital markets might curtail the current outstanding performance of the stock market. So, the stock market is a place where individuals in our society compete with one another in their investment decisions. Mr. Markey, my mother had some good advice to me, too. She always told me that when the Federal Government showed up in Chackbay with a sign on the corridor saying they were there to help us, we should be very leery. She also had a great Cajun expression that we often referred to, and it goes "Shacanasan goghe," which literally means—it is an expression of independence—"to each his own." That you make your own investments and you take your own chances in this great market we have and in this life we live.

I am not fully convinced that the government's investments in the surplus can be managed independently of political influence, regardless of how many goals we might establish or so-called independent investment boards we may create. I am deeply concerned, as Mr. Markey pointed out, about the changing political moods in this country. Indeed, will it be that in a couple of years from now, after we have allowed this to happen, that the law has suddenly changed to make sure that this independent board cannot invest in certain companies which the government at that time has a distaste for—or a dislike of their products?

I also wonder whether the Federal Government, as a fiduciary investing the surplus, will be held accountable to taxpayer investors for managerial malfeasance, just as broker dealers are now held accountable to their investment clientele. To that extent, I ultimately question whether our securities laws are going to be adequate in this new world of government investors competing with private investors and the complex mix of decisions that might be made for, and on behalf of, the taxpayers in general as private individuals are competing in that same market for their own interests.

These are just some of the primary concerns I have with the proposal, but I am, frankly, interested and willing to learn a great deal more and to understand and appreciate the concerns that I understand have already been expressed by Mr. Greenspan.

Mr. Greenspan, I have always looked upon you as one of the best in our government. I am just pleased that you are here, sir. And, I am anxious to learn from your testimony today. Thank you for coming.

Mr. OXLEY. The gentleman yields back. The Chair now recognizes the gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman. I really appreciate you holding this hearing.

I would like to thank you very much too, Chairman Greenspan, for coming.

Preserving the Social Security is the No. 1 domestic priority. I am heartened that there be bipartisan support for that goal. For almost 60 years, Social Security has been protected. The economic social security of American's retirees, disabled individuals, and children of deceased workers.

The Federal Old Age and Survivors Insurance Fund is the only popular economic and social program in the United States history because of its success eliminating widespread poverty among the elderly. Whatever reforms are adopted must not undermine the safety of our senior citizens.

I represent a district in New York. New York is the home of Wall Street, The New York Stock Exchange, the world premiere stock market, and most of this country's major investment banks, brokers, dealers, and money-managers. The Security Industry Association has testified in favor of Social Security privatization.

I am pleased that the subcommittee is holding this hearing and beginning the process of the issues raised by the President's plan. In his State-of-the-Union Address, the President proposed that 62 percent of the unified budget surpluses over the next 15 years be transferred to the Social Security Trust Fund in order to increase the ability of that fund to meet promised Social Security obligations. The President further proposed that about a fifth of the transferred surpluses be invested in equities to achieve higher returns for Social Security, helping to extend the life of Social Security Trust Fund to 2055.

This action does, however, raise understandable concerns about the possible extension of political influence on investment decisions and the risk that this might pose to the economy and the trust fund. Any system of connective investment can, and must, address these concerns.

I am taking no position on the President's plan at this time. It would be helpful to have a concrete legislative proposal on the table; I would feel a lot more comfortable. But, in any event, I look forward to hearing from Chairman Greenspan, of course, this morning and, later on, Secretary Lawrence Summer, later on this afternoon.

Whatever the outcome of this debate, experts agree that investing in the stock market, while helpful, is no panacea for what ails Social Security. In that regard, Mr. Chairman, I am hopeful that we will begin a dialog with the Ways and Means Subcommittee on Social Security earlier than later in this process. An effective solution is going to require us to work together and to draw our combined expertise.

Now, I understand some of the concerns, but I can't think that we also have to recognize that we just cannot stand around and continue to just sort of wiggle our thumbs. We have to begin to do something, else we will have a very difficult problem.

Thank you, and I yield back.

Mr. OXLEY. The gentleman yields back.

The Chair now recognizes the gentleman from Iowa, Mr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman.

Mr. Chairman, it appears to me that the President's Social Security proposal does not level with the American people. The President's budget forecasts a total of $4.5 trillion over the next 15 years. Of this surplus, $2.7 trillion already belongs to the Social Security Trust Fund because it comes from excess payroll taxes dedicated to pay for the future needs beyond the year 2012, when Social Security benefits will exceed income. For the remaining $1.8 trillion, the only true surplus, the President proposes to devote $1.7 trillion to new spending. But then, the President also plans to set aside 62 percent of the $4.5 trillion surplus, or $2.8 trillion, to extend the Trust Fund solvency from 2032 to 2055. So, the President's budget makes commitments and promises of $2.8 trillion, plus $1.7 trillion, plus $2.7 trillion, for a total of $7.2 trillion. But with only $4.5 trillion surplus, you can't do them all. It just simply does not add up. So, Mr. Chairman, maybe later today, Mr. Summers will be able to clarify that for us.

Now, the President's complex accounting, I think, undermines the efforts to save Social Security by lulling policymakers and citizens into a false sense of accomplishment.

A second element of the President's plan calls for the Federal Government to invest Social Security funds in the stock market. Under his plan, approximately $1.2 trillion of the trust fund would be used to buy up 4 percent of the stock market. Experts estimate this ownership share could compound to 20 percent, almost one fifth of the market. Turning the government into the largest shareholder in American business I think is a bad and dangerous idea. I think it could destroy the market, and it could hurt millions of investors across the country.

Our witness today, Mr. Greenspan, has testified saying that investing a portion of the trust fund assets and equities would, "arguably put at risk the efficiency of our capital markets and thus our economy." He goes on to say that, "even with Herculean efforts, I doubt it would be feasible to insulate, over the long run, the trust funds from political pressures, direct and indirect, to allocate capital to less than productive use." And, experience proves him correct.

At least 42 percent of State, county, and municipal pension systems have rules governing controlling types of allowable investments. In fact, then-Governor Clinton in Arkansas backed such social investment policies.

So, I think turning the government into the largest owner of American business would be a bad thing. It has been condemned by a wide range of financial and economic experts. Members of Congress, and both parties have expressed their concern, including such experts as Senator Moynihan of New York. Senator Moynihan, along with Senator Kerry of Nebraska, has a Social Security proposal that would allow an individual to invest 2 percent of the payroll tax into a retirement account similar to the Federal Employee Thrift Savings Plan.

I will be interested in asking Mr. Greenspan, and this afternoon, Mr. Summers, to comment on the viability of the Kerry/Moynihan proposal.

I yield back, Mr. Chairman.

Mr. OXLEY. The gentleman yields back. The gentleman from Michigan, Mr. Stupak.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. Chairman, this is our second hearing on investing Social Security in the market, and I thank you for holding these hearings. I know we are going to have more as we move on. I think it is noteworthy to note, Mr. Chairman, that for once, the Congress is talking about surpluses, in fact, we are talking about surpluses in the Federal Government which may total $4.3 million over the next 15 years.

We are at this point because, back in 1993, many of us helped to pass and put together, a deficit reduction package. Mr. Greenspan was, certainly, instrumental in giving us advice on that deficit reduction package. And, we took a step and we said it was going to be a tough vote, but we will do it to try to get the economy moving, get this country going in the right direction, and it worked. Now we are able to talk about surpluses.

And, I would add that only Democrats voted for that plan, but we are not now—as Democrats—are going to be the only ones to vote for the President's plan. In fact, because of the long, painful process we had to go through to get this country talking about surpluses, I am very cautious about this plan. I am undecided on what to do.

So, I look forward to hearing from our witness, Mr. Greenspan, today because I certainly respect his opinion on fiscal matters. I may disagree with him on the steel dumping issue that is currently going on in this country, but I guess what it shows is that reasonable people can, respectfully, disagree. And, I hope that when we make our decision at the end of the day about investing our surpluses in Social Security, whether it be in the private market or not, that we base it not upon disagreements, but, rather, on the information made available to us from all segments of our society, from all segments of the financial institutions and their representatives.

So, I certainly look forward to your testimony today, Mr. Greenspan, and that of Mr. Summers, the Deputy Secretary of Treasury, on what impact the President's proposal will have if we invest part of the surplus in the private financial market. So, I look forward to hearing from you, and I thank you for your service to this country and for your sound fiscal advice and we will talk about steel dumping some other time. Thank you.

Mr. OXLEY. The gentleman yields back.

The gentlelady from New Mexico, Mrs. Wilson.

Mrs. WILSON. Thank you, Mr. Chairman. I also want to thank Chairman Greenspan for testifying today.

I believe that this series of hearings, both in this subcommittee and others on the Hill, are very important as we are now engaged in a national discussion about how to make sure that Social Security is going to be there on time, and in full, for those who depend on it today as well as those who depend on it tomorrow.

I am also very pleased that so many on both sides of the aisle have committed themselves to preserving, protecting, and strengthening Social Security. Many of those in the Congress, myself included, have not seized upon one right answer to champion. At this point in our deliberations, I think that is good. Although, I think everyone should take Mr. Markey's French advice in searching for the answer to any situation: "Cherchez la femme," which means: "look for the woman." I don't think it is exactly what the French probably had in mind, but maybe Congresswoman DeGette and I can co-sponsor the solution to Social Security.

We are still studying the options, asking the questions, comparing notes, and listening to our constituents. I am committed to working toward a bipartisan solution guided by some basic principals with respect to Social Security.

First, the solution which we come up with must be fair to all generations, those that depend on it today, as well as those who enter the workforce today.

Second, Social Security should remain a social insurance program; it is the safety net. While over a long period of time individuals should be given more options about how their money is invested. In the State of New Mexico, which I represent, 60 percent of those who get Social Security checks have only Social Security checks to rely upon.

Third, we have to protect Social Security funds from being used for other government expenditures.

And, finally, the Federal budget surplus, now estimated at almost $1.5 trillion over the next 10 years, should be used first and foremost, to make sure that Social Security is solvent.

I have some serious reservations about allowing the Social Security Administration to invest directly in the stock market. Under such an arrangement, the Federal Government could quickly become the largest single owner of American businesses. And, no matter how many Chinese walls we place between government ownership and the corporate boardroom, I believe that this would put the government in a position of both owning and regulating companies, and that may not be good for America.

I do believe that we should consider some of the ideas about partial personalization of Social Security for those who want it and who are early in their working life. A small percentage of Social Security contributions could be put into an account with their name on it, similar to the Federal Employees Retirement System. And, as Mr. Greenspan has testified before on other committees, any investment strategy must include enough incentive for each American to monitor his or her own investment, and the ability to have some control over that investment.

Social Security should remain a social insurance program, the safety net for retirees, and for dependents who depend on Social Security checks being there in the post box on time, and in full. I believe that by working together for the common good that we can develop a plan, a bipartisan plan, to make sure that it will be there for those who depend on it.

I yield the balance of my time.

Mr. OXLEY. The gentlelady yields back. The gentlelady from Colorado, Ms. DeGette.

Ms. DEGETTE. Thank you, Mr. Chairman and thank you, again, for holding this hearing which, as you heard, is a second in what we hope are an ongoing series of hearings on this proposal to invest a portion of the Social Security Trust Fund in the stock market.

I agree with all of my colleagues that it is important how we are going to preserve Social Security for future generations and keep it strong. One of the intriguing proposals is to invest a portion of the retirement funds in the stock market. It is also one of the more dangerous proposals, possibly. And, like everyone else here, I am cautiously looking at different options.

I am very pleased to have the wisdom of Chairman Greenspan, and also, Secretary Summers, as we decide what the proper mix is and how will we accomplish this, both in the short and long run.

I really do understand the impetus between proposals to invest a portion of the Social Security Trust Fund in the stock market or even to set up private investment funds. Frankly, the markets have never been higher and, for this next generation below me, they have never known what it means to have a bear market. Suddenly, the 2.8 percent projected return on bond investments seems dismally low compared to higher market rates-of-return from equities.

While we all hope that the market continues on its historic high indefinitely, history tells us to act cautiously. We must carefully evaluate any proposed changes to the Social Security program—in part, to maximize our investment in the Nation's retirement plan. While public investment is appealing now, is it truly the only choice or the best choice for the Social Security Trust Fund, as well for the National economy?

One area of testimony I am looking forward to hearing is what happens to the rest of the economy, even if we just invest a small proportion of the trust funds in this way. Additional factors like government influence on markets and the impact of the mass of influx of 150 million retirees, investments would have to be carefully considered.

I hope today's hearings and the hearings in the weeks to come will shed some light on President Clinton's plan, and I also hope that today's testimony will further enlighten us on any plan that proposes investing money that the Federal Government has committed to every worker.

I would especially like to congratulate our chairman, as well as Mr. Dingell, for seeing the light that this important issue is one of the many issues that do remain in this subcommittee's and this committee's jurisdiction, and look forward to an ongoing conversation.

I yield back the balance of my time.

Mr. OXLEY. The gentlelady yields back. The gentleman from Illinois, Mr. Shimkus. The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Thank you, Mr. Chairman. I want to submit my entire statement for the record.

Mr. OXLEY. Without objection, all of the opening statements will be made a part of the record.

Mr. LARGENT. I would just say briefly, the one line that scares all of our constituents the most is when you say, "Hi, I am from the Federal Government and I am here to help you." And, I think they are probably equally concerned when we say "Hi, I am from the Federal Government and I am here to protect your Social Security check."

I am interested to hear the testimony of our witnesses today. I would like to hear their comments on the obvious conflict of interest of having the government be, not only the regulator, but the largest participant in the stock market and what the outcome of that may be. I am also interested to hear the witness' testimony on the President's proposal that he has put forward.

I have to say, briefly, Mr. Chairman, that I am excited that we are dealing with a debate and an issue as important as Social Security. Although I would say it is easy to talk about it, it is more difficult to do something about it.

I would say to all of the folks that are in our listening audience today that are generation X'es, if you truly believe that you are more likely to see life on another planet than ever see a Social Security check at your retirement, that you have an ability to participate in this debate by doing two simple things: registering to vote and voting. I would encourage you to do that.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Steve Largent follows:]

PREPARED STATEMENT OF HON. STEVE LARGENT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OKLAHOMA

Mr. Chairman, I want to commend you on holding these series of hearings to examine what may be arguably the most important issue Congress tackles this year—Social Security reform. I am extremely interested to hear what Chairman Greenspan and Deputy Secretary Summers thoughts are on the President's plan to invest a sizable portion of the projected $4.5 trillion budget surplus in the stock market, and what impact may result from having Uncle Sam as the major stockholder in corporate America?

I don't think there is much of an argument that it will take future retirees considerably longer to recoup what they have paid into the system as compared to current Social Security recipients. For example, according to the Congressional Research Service, workers who earned average wages and retired in 1980 at age 65 took 2.8 years to recover the value of what they and their employer paid in Social Security taxes plus interest. Fast forward twenty five years from now—it will take someone who retires in 2025 just over 26 years to recoup what he or she has paid into Social Security.

That leads to the obvious question as to why we are here today. Is it sound public policy to pass a law which would allow a portion of an envisioned budget surplus to be invested in the capital markets for the sake of a greater return on one's Social Security investment? Since coming to Congress I've become quite familiar with many laws, but probably the most important law I've learned is the law of unintended consequences. What may appear to have some merit in theory can prove to be less than meritorious when put into practice.

My other concern with the President's proposal, as I understand it, is that although his proposal decreases the publicly held debt, it would increase the total debt, which in turn requires raising the debt ceiling. Let me explain, assume that we have balanced budget except for Social Security which has a $100 surplus. Currently, under these circumstances Social Security would send the surplus to the Treasury in exchange for special issue treasury bills, meaning that they are only negotiable through Social Security.

These special issue treasury bills, which are essentially IOUs, are then deposited into the Social Security Trust Fund. At the end of the year, under this scenario, there is a $100 deficit in the unified budget. Under the President's proposal, $38 of the $100 surplus would be used for non-Social Security purposes such as Medicare, Defense and other so-called "high priority" spending programs. The remaining $62 would be returned back to Social Security. Since Social Security does not need the money because it is operating at a surplus, it reverts back to the Treasury in exchange for $62 in T-bills. Treasury then uses the $62 to pay down the public debt.

Under this scenario, the Social Security Trust Fund now has $162 in treasury bills, and this is where the accounting sleight-of-hand occurs. With a $100 surplus, Social Security has purchased itself $162 in Treasury bills. What happens when it comes time to repay the IOUs? Does Social Security receive $100 or $162. As far as I know, the President has not specified.

Another problem with the plan is that, in the past, Social Security has been self-sufficient through funding from payroll taxes. If we adopt the President's plan, we will now have to potentially repay the Social Security IOUs from general funds. Why you ask? In the scenario I have just laid out, when Social Security returns the $62 in exchange for T-bills, it receives general revenue T-bills, and not special issue T-bills as we have done in the past. General revenue T-bills are what is known as "first order" debt. It would be analogous to a bankruptcy proceeding in which all the debts are ranked according to the order in which creditors must be repaid. General revenues are at the top of the list and must be paid out of general revenue. By involving the general fund in Social Security, we create an opportunity for true fiscal irresponsibility as Congress would now no longer have to make the tough choices of raising payroll taxes or lowering benefits—we simply take on more general debt.

Mr. Chairman, I think the President's proposal creates more problems than it solves, but I'm interested in hearing what our witnesses have to say about how we should proceed with preserving the solvency of Social Security.

Mr. OXLEY. The gentleman yields back. The gentleman from Wisconsin, Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman. First of all, I want to thank you for holding these hearings. This is actually the first hearing I have been to under your leadership and it has been a life-long dream of mine to serve on your subcommittee. So, I am very pleased to be here with you today.

I want to say that this issue is the most important domestic issue, obviously, that we face as a Nation. And, at the same time, there is no issue easier to demagogue than Social Security. I think everybody at this panel recognizes that if we are going to truly address the problems of Social Security, Democrats and Republicans have to hold hands together and jump off whatever cliff there is. I am hoping that the cliff is only about 2 inches high. But this is something that we have to deal with on a bipartisan basis.

For that reason, I am pleased that the President has come forward with a proposal. I think, for a long time, both parties were saying "After you," "No, after you," "After you," because nobody wanted to take the first step in what certainly could be a very hostile debate. But now we have something to debate, and I very much look forward to hearing the thoughtful comments of Mr. Greenspan because I think that he is going to allow us to move the debate forward. I am sure his comments, as well as Mr. Summers' comments, will, ultimately, lead this Congress to moving forward and actually addressing what I considered to be the most important domestic issue we face.

I yield back my time.

Mr. OXLEY. The gentleman yields back. The gentleman from Arizona, Mr. Shadegg.

Mr. SHADEGG. I thank you, Mr. Chairman, and I will submit my full written statement for the committee, but I just merely want to observe that today's hearing brings me back to 4 years ago. I sit here as a freshman on this committee this year because I just joined the committee, and it reminds me of 4 years ago when I joined the Congress and was a freshmen. Like today, I then sat in the front row in a committee hearing where our esteemed guest, Mr. Greenspan, was going to testify. That time, it was the budget hearing and we were all debating hotly, as we are today, the reform of Social Security. Then, we were debating the Republican majority's proposals for shrinking the size of government and for cutting Federal spending. That particular hearing was my first hearing on the Budget Committee.

I sat in the front row in front of Mr. Kasich and the debate went on, rather intently, over the Republican proposals to slow the growth of the Federal Government. And, the discussion went back and forth from each side of the aisle. And, finally, we got toward the end of the discussion and one of my colleagues from the other side asked Mr. Greenspan, after expressing his deep concern about the cuts that were being discussed—we all, of course, know they weren't really cuts; they were slowing the rate of growth of the government—but this colleague from the other side of the aisle asked Mr. Greenspan if he was not, indeed, concerned that if the majority was successful in reducing government spending in the fashion they were then proposing, that there would be dislocation and damage to the economy?

Mr. Greenspan, who may recall this moment, sat back for a moment and looked at my colleague and said, "Son, I have been around this town a long time and I lose little sleep worrying that the Congress will cut spending too far or too fast."

I believe Mr. Greenspan was right then, and I think he is also right about his concern about the notion of having the government become the largest investor in the private stock market. I am anxious to hear his comments today, as I was then.

I would associate myself with the comments of my colleagues here. This is, indeed, a very important issue, but an issue on which we can make grave mistakes and we should be very cautious about how we proceed.

I yield back the balance of my time.

[The prepared statement of Hon. John Shadegg follows:]

PREPARED STATEMENT OF HON. JOHN B. SHADEGG, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ARIZONA

Thank you Chairman Oxley for your leadership on this issue and thank you Chairman Greenspan for appearing before this subcommittee today to address our concerns surrounding certain aspects of the President's Social Security proposal. The President has proposed using $2.8 trillion of the $4.5 trillion projected budget surplus over the next 15 years to shore up Social Security. Twenty-one percent of that $2.8 trillion—or *$588 billion*—will be directly invested in the stock market by the federal government under the President's plan.

For several years now, a great deal of attention has been given to the anticipated decline of the Social Security system and proposals to save the system. As we all know, an aging U.S. population combined with a shrinking workforce will result in increased benefits to retirees but fewer tax receipts for the Social Security account. Experts estimate that as early as 2013, just as the baby boomers begin to retire, Social Security will become dependent upon other federal receipts, including the interest currently paid to the trust funds. And as early as 2026, Social Security will be insolvent.

There are, essentially, three options for saving Social Security: increase taxes, decrease benefits, or increase the rate of return of Social Security funds. Considering that I am a strong advocate of reducing the tax burden on the American people, I could not, and will not, support any proposal to save Social Security that would result in a tax increase. Furthermore, I am not inclined to support lowering Social Security benefits to today's retirees, and those who will retire in future years. I don't imagine either group would support it as well. This leaves us with the option of increasing the rate of return on Social Security funds. I look forward to hearing Chairman Greenspan's comments as to the effects of government investing in the capital markets.

I strongly believe in the tenets of individual liberty and individual responsibility. I have long supported legislation that reduces the size and scope of the federal government and returns power to the American people. For these reasons, I am inclined to support the use of personal retirement accounts to invest in the stock market and to provide for America's retirees in the future. I am confidant that today's discussion will spark a renewed interest in a Social Security proposal that includes the use of personal retirement accounts.

Although proponents of the President's Social Security plan are confident that an independent investment board could be insulated from political pressures, I have serious doubts about the government's ability to maintain objectivity when investing in companies that are not politically appealing, such as the tobacco companies. Furthermore, I am deeply concerned about government ownership of private corporations not only because this would be a dangerous step away from our capitalist economy, but also because of the potential and likely negative impact on the market itself

Finally, current state and local pension funds have been cited as models for the President's proposal. I would simply point out one significant distinction between these pension programs and the system that would be established under the President's proposal: these state pension funds provide retirement benefits *only* to state government employees and not to the residents of the entire state. However, the President's proposal would include *every single American*.

Again, I am anxious to hear from Chairman Greenspan, and later Dr. Summers on the President's proposal and the potential market impact of the federal government investing in the capital markets, including your thoughts on investor protections and corporate governance in those markets. I believe we can all agree that many unanswered questions remain regarding the President's proposal.

I look forward to discussing these points and yield back the balance of my time.

Mr. OXLEY. The gentleman yields back. The gentleman from Texas, our good friend, Mr. Hall.

Mr. HALL. Mr. Chairman, I will put my statement in the record, and I thank Mr. Greenspan. I think he is really one of the great Americans. We are honored to have him here. I thank him for what he has done and I thank him for what he has done for this country.

I yield back my time.

Mr. OXLEY. The gentleman yields back. The gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. I, too, want to welcome the Chairman here, I do have great respect for you and what you have done. It is one of the privileges of being a Member, getting a chance to interact with folks who serve the country so well.

I unintentionally touched the Third Rail of politics in 1992, when I was stressing the need to balance the Federal budget. Throughout the rest of the campaign, I was demagogued as one who wanted to steal the retirements of individuals. So, I also am excited. We really have come a great distance in the society to be able to have hearings openly on how do we address the upcoming problems. And, I am excited to be a participant in that debate.

The simple law of economics is supply and demand—and I will be listening for two issues, hopefully, in the debate—one is the supply and-demand issues of investing into the capital markets by the Federal Government and how that all shakes out; and another proposal, which may not get addressed today, but if we were to take the Social Security tax revenue and pay down the national debt, how would those supply and-demand aspects affect—you may not want to address—interest rates across the board; and, actually, the longevity of a position, in which, we can then sit down and address saving Social Security for future generations.

Again, Mr. Chairman, thank you for holding this hearing and again, welcome to Chairman Greenspan. And, I look forward to the rest of the hearing.

Mr. OXLEY. The gentleman yields back. The gentleman from Pennsylvania, Mr. Greenwood.

Mr. GREENWOOD. Thank you, Mr. Chairman. I have been sitting here contemplating the number of hours of his life Mr. Greenspan has spent enduring opening statements, and it has inspired me not to give one. I yield back.

Mr. OXLEY. That was brilliant.

The gentleman from California, Mr. Bilbray.

Mr. BILBRAY. Regretfully, Mr. Greenspan, I am not so merciful.

Mr. Chairman, I would just like to say that I am encouraged by how many young, or younger, people I see in this room today. I think, if you look around, you do not see the group that usually is discussing Social Security. And, that is appropriate because we are not talking about present recipients of Social Security; we are not talking about senior citizens of today. We are talking about those of us who will be senior citizens of tomorrow.

Mr. Chairman, we are not just talking about dollars and cents when we talk about the future of Social Security. I think we are talking about trust and credibility. I think the one thing that the younger generations of America will acknowledge is there is not much trust in the fact that Social Security will be there when we want it, especially, with those who are younger, much younger, than those of us who are baby-boomers.

I only have a question, again, that keeps raising to me. I am from California. In California if a government official uses trust funds for anything other than what the trust fund is for, it not only raises concerns, it raises legal questions, and that includes the interest generated by the trust funds. Now I may be wrong, but at least there seems to be a perception, for those of us who come from the West Coast, and from a lot of young people, that Social Security Trust Fund has, since the 1960's, been used as a slush fund. And that the promise: "Don't worry, trust us; we will get the money back when you need it," is something that a lot of young people don't really believe at this time.

Now, I know that, since the 1960's, it has been technically legal to use Social Security funds and the so-called surplus. It is interesting to hear how many fathers of success there is in Congress where a 1993 tax increase taxed our way into prosperity. The Republicans can point out, since 1995, that there has been a control of spending. But, that aside, is the fact that we can change the laws here in Washington, but we can't change the laws of nature, which is, when you have the money, and you can spend it on something else, you usually do.

I think that we need to discuss that. I think that Mr. Greenspan is here and has a lot more credibility than anyone else involved in this issue. I think we tried to place too much responsibility on Mr. Greenspan because he is one of the few people that people really give some credence to his credibility. Maybe that is because he is the one guy who shot straight and continues to shoot straight in this town. I think, the young people look to Mr. Greenspan, basically, to shine the light on the truth, get beyond the partisan posturing, and actually talk about what needs to be done.

I look forward to addressing this issue. I want to make sure that we are not talking about a baby-boomer in the White House using, what our generation called, "new math" to double-count and triple-count so-called surpluses so we can justify our strategies. I think that all of us that are the baby-boomers bear the responsibility to make sure the next generation gets as much benefits out of the Social Security System as we do. Our challenge, I think, here today and in the future is to make sure those young people that are sitting in this crowd and out in the American people start developing the kind of trust for the system that the system was meant to have prior to the creative financing of the 1960's that has continued for over 30 years.

Thank you, Mr. Chairman. I yield back.

Mr. OXLEY. The gentleman yields back. The gentleman from Maryland, Mr. Ehrlich.

Mr. EHRLICH. I would adopt the remarks from the gentleman from Pennsylvania and just simply welcome the Chairman.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. PAUL E. GILLMOR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Now that the proposal is out there of using the equity markets in one form or another to help finance Social Security, we need to carefully examine the proper roles of the public and private sectors. What does the government do better than the private sector? What do the equity markets do better than the government?

Regarding the return on Social Security funds, it is clear that the private markets, over time, offer superior returns. In as much as the equity markets provide better returns, we have an interest in exploring this option. That's because each dollar of increased return the stock markets can provide for the Social Security trust funds, represents one dollar less the government needs to raise taxes or reduce benefits.

While finding a better return on Social Security may temporarily stall the depletion of the trust funds, this fails to address the underlying question: How can we get workers to save and invest more for themselves?

Recently, one 48 year old worker from Northwest Ohio called my office and stated that he would be willing to give up everything he has paid into Social Security in exchange for being allowed to invest his share of his payroll taxes. This individual knows that, as a pay-as-you-go program, the money that he has put into Social Security isn't actually being held for him when he retires. And that is why he is willing to give up everything he has paid in return for the opportunity to know that he has his own individual account. There is a certain sense of security derived from owning a personal account established from your own paycheck.

Besides the concerns about federal ownership of corporate America, this is one reason why I think if we move at least some of the Social Security dollars into the private markets, American workers, not the federal government, should privately own such accounts.

One of our witnesses last week pointed that an individual's Social Security taxes are mandatory payments owned by the government. State pension systems, however, are for people who voluntarily work for the state. And plans like the Federal Thrift Savings Plan allow federal workers to contribute various amounts to their pension system. It seems to me that allowing workers to divert at least some of their mandatory payments into individually owned accounts would provide for better returns and increase control and confidence in the system.

I know our distinguished panels will provide their expertise and insight into these questions.

Thank you, Mr. Chairman.

Mr. OXLEY. We now turn to our distinguished witness, the Honorable Alan Greenspan. Chairman Greenspan, again, welcome to the committee. We appreciate your sincere interest in this issue and we appreciate your patience during the opening statements.

STATEMENTS OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM; AND LAWRENCE H. SUMMERS, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. GREENSPAN. Thank you very much, Mr. Chairman. I very much appreciate the opportunity to appear before you and the other members of the committee.

Preparing for the retirement of the babyboom generation looms as one of our Nation's most difficult challenges, and I commend the serious efforts being made here to address this important long-term problem. Mr. Chairman, before discussing my views on the issue of investing the Social Security Trust Fund in equities, I would like to examine the more fundamental issues that any retirement reform will have to address.

The dramatic increase in the ratio of retirees to workers that seems inevitable, as the babyboom generation moves to retirement and enjoys ever greater longevity, makes our current pay-as-you-go Social Security System unsustainable. Furthermore, the broad support for Social Security appears destined to fade as the implications of its current form of financing become increasingly apparent. To date, with the ratio of retirees to workers having been relatively low, workers have not considered it a burden to share the goods and services they produce with retirees. The rising birth rate after World War II, which, in due course, contained the growth of the ratio of retirees to workers, helped make the Social Security program exceptionally popular, even among those paying the taxes to support it.

Indeed, workers perceived it to be a good investment for their own retirement. For those born before World War II, the annuity value of benefits on retirement far exceeded the cumulative sum at the time of retirement of contributions by the worker and his or her employer, plus interest. For example, the implicit real rate of return on Social Security contributions was almost 10 percent for those born in 1905, and was about 6 percent for those born in 1920. I am talking about real rates of return, not as adjusted for inflation. The real interest rate, by contrast, on U. S. Treasury securities, has generally been below 3 percent.

But, births flattened after the babyboom, and life expectancy beyond age 65 continued to rise. Consequently, the ratio of the number of workers contributing to Social Security to the number of beneficiaries has declined to the point that maintaining the annuity value of benefits on retirement at a level well in excess of accumulated contributions has become increasingly unlikely. Those born in 1960, for example, are currently calculated to receive a real rate of return, on average, of less than 2 percent on their cumulative contributions. Indeed, even these low rates of return for more recent cohorts likely are being overestimated, because they are based on current law taxes and benefits. In all likelihood, short of a substantial infusion of general revenues, Social Security taxes will have to be raised, or benefits cut, given that the system as a whole is still significantly underfunded, at least according to the intermediate projections of the Old-Age and Survivors Insurance actuaries. For the present value of current law benefits over the next 75 years to be fully funded through contributions, Social Security taxes would have to be raised about 2.2 percent of taxable payroll right now; to be fully funded in perpetuity, that is, to ensure that taxes and interest income will always be sufficient to pay benefits, Social Security taxes would have to be raised much more—perhaps something on the order of four to 5 percent of taxable payroll.

The issue of funding underscores the critical elements in the forthcoming debate on Social Security reform, because it focuses on the core of any retirement system, private or public. Simply put, enough resources must be set aside over a lifetime of work to fund retirement consumption. At the most rudimentary level, one could envision households saving by actually storing goods purchased during their working years for consumption during retirement. Even better, the resources that would have otherwise gone into the stored goods could be diverted to the production of new capital assets, which would, cumulatively, over a working lifetime, produce an even greater quantity of goods and services to be consumed in retirement.

The only way we will be able to finance retirement incomes that keep pace with workers' incomes is to substantially increase the national saving rate, increase the borrowing of foreign capital, or increase the output that a given capital stock, financed through this saving, can produce. The crucial retirement funding issues center on how to increase our national saving and how to allocate physical resources between workers and retirees in the future. We must endeavor to increase the real resources available to retirees without blunting the growth in living standards among our working population.

In this light, increasing our national saving is essential to any Social Security reform. Privatization proposals that begin to address Social Security's existing unfunded liability would significantly enhance domestic savings; so would fuller funding of the current Social Security program. But the size of the unified budget surplus implied by such funding, many have argued, would be politically unsustainable. It would be in the trillions. I should say it is in the trillions over time and especially as we get into the middle parts of the next century. The President, recognizing this political risk, has proposed changing the budgetary framework so as to support a large unified budget surplus. This is a major step in the right direction that, if effective, would ensure that the current rise in government's positive contribution to national saving is sustained. The large surpluses projected over the next 15 years, if they actually materialize, would significantly reduce the fiscal pressures created by our changing demographics. Whichever direction the Congress chooses to go, whether toward privatization or fuller funding of Social Security, augmenting our national saving rate has to be the main objective.

The administration has also proposed investing a portion of the Social Security Trust Fund assets in equities, rather than in U.S. Treasuries alone. Having the trust fund invest in private securities most likely would increase its rate of return, although the increase might be less than historical rates of return would suggest, and certainly would be less on a properly risk-adjusted basis. But where would that higher return come from, and what would happen to private funds available for consumption in retirement?

If Social Security trust funds are shifted from U.S. Treasury securities to private debt and equity instruments, holders of those securities in the private sector must be induced to exchange them, on net, for U.S. Treasuries. Private pension and insurance funds, among other holders of equities, presumably would swap equities for Treasuries. It seems likely that a rise in the interest rate paid on Treasuries, and perhaps an increase in equity prices and a reduction in the expected future return on equity, would be necessary in order to induce private investors to reallocate their portfolios from equities to U.S. Treasury securities. If this is indeed the case, then the net increment to the government of investing the trust fund in equities on an ongoing basis presumably would be less than the historical rates of return suggest. That said, exactly what changes in bond and stock prices would result from this type of large-scale swap of U.S. Treasuries for equities is extremely difficult to predict.

But analyzing the macroeconomic effects of the portfolio reallocation is much less complicated. The transfer of Social Security assets from U.S. Treasuries to equities would not, in itself, have any effect on national saving. Thus, the underlying economic assets in the economy would be unchanged, as would the total income generated by those assets. Any increase in returns realized by the Social Security must be offset by a reduction in returns earned on private portfolios, which represent, to a large extent, funds also held for retirement. Investing Social Security assets in equities is, then, largely a zero-sum game. To a first approximation, aggregate retirement resources—from both Social Security and private funds—do not change.

Only an increase in national saving or an increase in the efficiency with which we use our saving can help us meet the retirement requirements of the coming years. Indeed, improved productivity of capital probably explains much of why the American economy has done so well in recent years despite our comparatively low national saving rate. For productivity and standards of living to grow, financial capital raised in markets or generated from internal cash-flow from existing plant and equipment must be continuously directed by firms to its most profitable uses—namely, new physical capital facilities perceived as the most efficient in serving consumers' multiple preferences. It is this continuous churning, this so-called creative destruction, that has become so essential to the effective deployment of advanced technologies by this country over the recent decades.

Looking forward, the effective application of our capital to its most highly valued use is going to become, if anything, more important, as we strive to increase the resources available to provide for the retirement of the baby boomers without, in the future, significantly reducing the consumption of workers. An efficient market pricing mechanism for equities has been a key element in our superior allocation of saving into investment this past decade. Large investments in equities by the Social Security Trust Funds could impair that process.

As I have indicated in earlier testimony, I doubt that it is possible to secure and sustain institutional arrangements that would insulate, over the long run, the trust funds from political pressures. These pressures, whether direct or indirect, could result in suboptimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise.

The experience of public pension funds seems to bear this out. Although relevant comparisons to private plans are difficult to construct, there is evidence that the average rate of return on State and local pension funds tends to be lower than the return realized on comparable private pension funds.

As I have also indicated in previous testimony, I do not deny that the Federal Government can manage equities without political interference if they are held in defined contribution funds or small defined benefit plans, such as the one run by the Federal Reserve. Defined contribution funds, such as the Federal Government's Thrift Savings Plan, are effectively self-policed by individual contributors, who would surely object were their retirement assets to be diverted to investments that offered less than market returns.

But government defined benefit plans, like Social Security, provide guaranteed annuities that are wholly insulated from poor investment performance. Annuitants look to the Federal Government for their retirement incomes, not the performance of any trust funds. Thus, beneficiaries have no incentive to monitor the performance of their investments. And, while the government's small defined benefit funds do not reach the asset size threshold to make them a target, a multi-trillion dollar Social Security Trust Fund presumably would.

It is possible that institutions could be created that would prevent the trust fund investments from being subject to political interference. But, investing the Social Security Trust Funds in equities does little or nothing to improve the overall ability of the U.S. economy to meet the retirement needs of the next century. Given this lack of evident benefit, it is unclear to me why we should take on the risk of interference, which, probably short of a Constitutional amendment, cannot be eliminated. Even if concerns about politically driven investment were not to materialize, what would have been gained by such a huge shuffling of funds?

To the extent that a transfer of private retirement resources to Social Security is deemed necessary to fund currently promised benefits, why not do it directly through increased Social Security taxes, or an allocation of general revenues to the Social Security Trust Fund? Whatever the Congress does, it would be best not to obscure the choice of real resource allocation with complex financial structures that merely reshuffle claims to real resources, without increasing them.

Of course, assessing the fiscal, financial, and economic state of the American economy in the early twenty-first century is an enormously difficult undertaking. We cannot confidently project large surpluses in our unified budget over the next 15 years, given the inherent uncertainties of budget forecasting. How can we ignore the fact that virtually all forecasts of the budget balance have been wide of the mark in recent years? For example, as recently as February 1997, OMB projected a deficit for fiscal year 1998 of $121 billion—a $191 billion error. The CBO and others made similar errors. Likewise, in 1983, we confidently projected a solvent Social Security Trust Fund through the year 2057. Our latest estimate, with only a few changes in the program, is 2032.

It is possible, at some maintain, that the OASI actuaries are too conservative, and that productivity growth could be far greater than is anticipated in their so-called "intermediate" estimate. If this is, in fact, our prospect, the Social Security System is in less jeopardy than it currently appears. But proper fiscal planning requires that consequences of mistakes in all directions be evaluated. If we move now to shore up the Social Security program, or replace it, in part or in whole, with a private system, and subsequently find that we had been too pessimistic in our projections, the costs to our society would be few. If we assume more optimistic scenarios and they prove wrong, the imbalances could become overwhelming, and finding a solution would be even more divisive than today's problems.

Thank you, Mr. Chairman. I would appreciate my full text be included for the record.

[The prepared statement of Hon. Alan Greenspan follows:]

PREPARED STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. Chairman and other members of the committee, preparing for the retirement of the baby boom generation looms as one of our nation's most difficult challenges, and I commend the serious efforts being made here to address this important long-term problem. Before discussing my views on the issue of investing the social security trust fund in equities, I would like to examine the more fundamental issues that any retirement reform will have to address.

The dramatic increase in the ratio of retirees to workers that seems inevitable, as the baby boom generation moves to retirement and enjoys ever greater longevity, makes our current pay-as-you-go social security system unsustainable. Furthermore, the broad support for social security appears destined to fade as the implications of its current form of financing become increasingly apparent. To date, with the ratio of retirees to workers having been relatively low, workers have not considered it a burden to share the goods and services they produce with retirees. The rising birth rate after World War II, which, in due course, contained the growth of the ratio of retirees to workers, helped make the social security program exceptionally popular, even among those paying the taxes to support it.

Indeed, workers perceived it to be a good investment for their *own* retirement. For those born before World War II, the annuity value of benefits on retirement far exceeded the cumulative sum at the time of retirement of contributions by the worker and his or her employer, plus interest. For example, the implicit real rate of return on social security contributions was almost 10 percent for those born in 1905, and was about 6 percent for those born in 1920. The real interest rate on U.S. Treasury securities, by comparison, has generally been below 3 percent.

But, births flattened after the baby boom, and life expectancy beyond age sixty-five continued to rise. Consequently, the ratio of the number of workers contributing to social security to the number of beneficiaries has declined to the point that maintaining the annuity value of benefits on retirement at a level well in excess of accumulated contributions has become increasingly unlikely. Those born in 1960, for example, are currently calculated to receive a real rate of return, on average, of less than 2 percent on their cumulative contributions. Indeed, even these low rates of return for more recent cohorts likely are being overestimated, because they are based on current law taxes and benefits. In all likelihood, short of a substantial infusion of general revenues, social security taxes will have to be raised, or benefits cut, given that the system as a whole is still significantly underfunded, at least according to the intermediate projections of the Old-Age and Survivors Insurance

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The Administration has also proposed investing a portion of the social security trust fund assets in equities, rather than in U.S. Treasuries alone. Having the trust fund invest in private securities most likely would increase its rate of return, although the increase might be less than historical rates of return would suggest, and certainly would be less on a properly risk-adjusted basis. But where would that higher return come from, and what would happen to private funds available for consumption in retirement?

If social security trust funds are shifted from U.S. Treasury securities to private debt and equity instruments, holders of those securities in the private sector must be induced to exchange them, on net, for U.S. Treasuries. Private pension and insurance funds, among other holders of equities, presumably would swap equities for Treasuries. It seems likely that a rise in the interest rate paid on Treasuries, and perhaps an increase in equity prices and a reduction in the expected future return on equity, would be necessary in order to induce private investors to reallocate their portfolios from equities to U.S. Treasury securities. If this is indeed the case, then the net increment to the government of investing the trust fund in equities on an ongoing basis presumably would be less than the historical rates of return suggest. That said, exactly what changes in bond and stock prices would result from this type of large-scale swap of U.S. Treasuries for equities is extremely difficult to predict.

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Only an increase in national saving or an increase in the efficiency with which we use our saving can help us meet the retirement requirements of the coming years. Indeed, improved productivity of capital probably explains much of why the

American economy has done so well in recent years despite our comparatively low national saving rate. For productivity and standards of living to grow, financial capital raised in markets or generated from internal cash flow from existing plant and equipment must be continuously directed by firms to its most profitable uses—namely new physical capital facilities perceived as the most efficient in serving consumers' multiple preferences. It is this continuous churning, this so-called creative destruction, that has become so essential to the effective deployment of advanced technologies by this country over recent decades.

Looking forward, the effective application of our capital to its most highly valued use is going to become, if anything, more important, as we strive to increase the resources available to provide for the retirement of the baby boomers without, in the future, significantly reducing the consumption of workers. An efficient market pricing mechanism for equities has been a key element in our superior allocation of saving into investment this past decade. Large investments in equities by the social security trust funds could impair that process.

As I have indicated in earlier testimony, I doubt that it is possible to secure and sustain institutional arrangements that would insulate, over the long run, the trust funds from political pressures. These pressures, whether direct or indirect, could result in suboptimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living than would be achieved otherwise.

The experience of public pension funds seems to bear this out. Although relevant comparisons to private plans are difficult to construct, there is evidence that the average rate of return on state and local pension funds tends to be lower than the return realized on comparable private pension funds, other pooled investments, and market indexes. Of course, a significant part of this disparity would be eliminated were these returns adjusted for risk, because public pension plans are often invested more conservatively than private plans. But there is evidence that returns are lower even after accounting for differences in the portfolio allocation between stocks and bonds. For example, it has been shown that state pension plans that are required to direct a portion of their investments in-state and those that make "economically targeted investments" experience lower returns as a result. Similarly, there is evidence suggesting that, the greater the proportion of trustees who are political appointees, the lower the rate of return. A lower risk-adjusted rate of return on financial assets is almost invariably an indication of lower rates of return on the real underlying assets on which they are a claim.

As I have also indicated in previous testimony, I do not deny that the federal government can manage equities without political interference if they are held in defined contribution funds or small defined benefit plans, such as the one run by the Federal Reserve. Defined contribution funds, such as the federal government's Thrift Savings Plan, are effectively self-policed by individual contributors, who would surely object were their retirement assets to be diverted to investments that offered less than market returns.

But government defined benefit plans, like social security, provide guaranteed annuities that are wholly insulated from poor investment performance. Annuitants look to the federal government for their retirement incomes, not the performance of any trust funds. Thus, beneficiaries have no incentive to monitor the performance of their investments. And, while the government's small defined benefit funds do not reach the asset size threshold to make them a target, a multi-trillion dollar social security trust fund presumably would.

It is possible that institutions could be created that would prevent the trust fund investments from being subject to political interference. But, investing the social security trust funds in equities does little or nothing to improve the overall ability of the U.S. economy to meet the retirement needs of the next century. Given this lack of evident benefit, it is unclear to me why we should take on the risk of interference, which, probably short of a Constitutional amendment, cannot be eliminated. Even if concerns about politically driven investment were not to materialize, what would have been gained by such a huge shuffling of funds?

To the extent that a transfer of private retirement resources to social security is deemed necessary to fund currently promised benefits, why not do it directly through increased social security taxes, or an allocation of general revenues to the social security trust fund? Whatever the Congress does, it would be best not to obscure the choice of real resource allocation with complex financial structures that merely reshuffle claims to real resources, without increasing them.

A collateral issue is relevant to this debate. If the Congress were to decide to do nothing to alter the path of receipts and outlays projected under current law, a large buildup in the social security trust fund would occur, along with a significant on-budget surplus, according to the projections of CBO and OMB. The consequence would, of course, be a significant decline in the current $3¾ trillion outstanding federal debt to the public.

But, if the unified budget is in surplus for a protracted period of years, it is at least conceivable that the outstanding public debt would be eliminated. I might add that this would be the first such occurrence for this nation, the previous low having been $38 thousand in 1835 and 1836.

Currently, the rise in the holdings of U.S. Treasuries by the social security trust fund is accomplished by the Treasury redeeming or buying back debt from the public, and selling it as special series nonmarketables to the trust fund. But, should the debt to the public fall to zero, there would be no additional Treasury instruments available to the trust fund from that source. Were the Treasury, nonetheless, to continue to sell debt to the trust funds, its cash balances at the Federal Reserve would build up. At that point, under existing policy, there would be no choice but to have the social security trust fund invest in private or quasi-private agency securities. I grant that, should these circumstances arise, the decision of how to handle social security investments would become a more pressing question. However, it is exceptionally difficult for me to focus seriously on so politically improbable, though so intriguing, an event.

Of course, assessing the fiscal, financial, and economic state of the American economy in the early twenty-first century is an enormously difficult undertaking. We cannot confidently project large surpluses in our unified budget over the next fifteen years, given the inherent uncertainties of budget forecasting. How can we ignore the fact that virtually all forecasts of the budget balance have been wide of the mark in recent years? For example, as recently as February 1997, OMB projected a deficit for fiscal year 1998 of $121 billion—a $191 billion error. The CBO and others made similar errors. Likewise, in 1983, we confidently projected a solvent social security trust fund through 2057. Our latest estimate, with only a few changes in the program, is 2032.

It is possible, as some maintain, that the OASI actuaries are too conservative, and that productivity growth could be far greater than is anticipated in their "intermediate" estimate. If that is, in fact, our prospect, the social security system is in less jeopardy than it currently appears. But proper fiscal planning requires that consequences of mistakes in all directions be evaluated. If we move now to shore up the social security program, or replace it, in part or in whole, with a private system, and subsequently find that we had been too pessimistic in our projections, the costs to our society would be few. If we assume more optimistic scenarios and they prove wrong, the imbalances could become overwhelming, and finding a solution would be even more divisive than today's problem.

Mr. OXLEY. Without objection, so ordered. Again, we appreciate your being with us today.

The Chair will begin a round of questions for the Chairman.

As I understand your testimony, the two goals that you addressed were the long-term future of Social Security and to increase the national savings rate. And, you mentioned specifically the Federal Government's Thrift Savings Plan, which all Federal workers since, I think, 1984, are required to participate in—or the Federal Employees Retirement System—and the option of the Federal Government's Thrift Savings Plan.

As you know, Mr. Chairman, that has a choice of, essentially, three funds, the first one being the C Fund, the stock index fund, based on the S&P 500. The second is the bond index Fund A bond and X bond, and the third is a government securities provision that basically provides a set amount, thereby giving Federal employees who chose to participate essentially a choice of the risk that they wish to take with their own money.

If we were crafting a proposal that would provide an increase in the national savings rate as well as buttress existing Social Security for a number of years, would we be in the right neighborhood if we were to use the Federal plan as an opportunity to explore how we would craft a privatization of part of the Social Security System?

Mr. GREENSPAN. I would certainly think so, Mr. Chairman. Remember, however, we are talking about a defined contribution plan. Its return will be high or low, depending on the success of the investments. And, there is, of course, no guaranteed annuity at the end of one's working life as there is in a private annuity system or in Social Security. So, in evaluating that, one must keep that in mind. But if you are asking whether or not something of that nature is a model for individual retirement accounts or a quasi-privatization, I would say it is certainly the beginning from where one should start to look.

Mr. OXLEY. I know when I have the opportunity to discuss this with my constituents, which is quite often, and many of them aren't aware of the Federal system, I explain the Federal system. Their response is, if it is good enough for Federal workers, why isn't it good enough for us? Particularly in regard to the baby-boomers and the generation X'ers, who by every poll indicate that they have very little faith that, when they are of retirement age, they will be able to get Social Security in any form.

And, even if they were—because as you indicated in your remarks, the return would be less than 2 percent, and this is one of the things that I think Congress really has to deal with—I think you were very forthright in saying that there is very little chance that you could craft a system whereby the Federal Government would invest into the Social Security System without fear of political pressure. Also interesting, I think, is when you said that investing would not really increase the national savings rate. I think it is something that I, frankly, have not considered, but was most interested in pursuing.

Mr. Chairman, we had testimony last week, and also toward the end of last year from James Glassman, who is an economist who writes a regular column for The Washington Post. He indicated that over the long term—that is, from 1929 until the present—the most return on investment actually came from equities that averaged about over that period. That includes the Great Depression and the stock market crash, and again we are talking long-term for retirement for baby-boomers and for generation X'ers. That return was 7 percent, which was far greater than bonds or very secure government securities. Do you share that same confidence that over the long-term—again, knowing the ups and downs of the market—that indeed the most secure investment and the highest return is an equity?

Mr. GREENSPAN. We have to start with the general notion of where all of this earnings and interest comes from. These are claims on real goods and services that are produced. What happens when one looks at the historical record is what you do see is that the so-called equity premium, meaning the persistence of the rate of return in equities over riskless debt, seems always to be positive. That is, people tend to be risk-averse and as a consequence of that, they appear to be inevitably pricing debt in a manner in which they would be willing to accept a lower real rate of return on debt instruments which they consider less risky than equities. As a consequence of that, it is true over a long period of time that equities do yield more than debt instruments. But remember that when you shift the equities from one part of the system—namely, the private system into the public system—you are not changing the overall rate of return. You are just shuffling back between various different segments of the economy.

If you lower the degree of leverage in the economy—meaning, increase the amount of equity and decrease the amount of debt—then the rate of return on equity will probably become somewhat less because it will become an admixture of the previous interest payments with the equity returns.

Given the fact that the total gross operating profit—if I may put it that way—is determined independently of whether, in fact, there is a significant mix of equities or debt, I say that as a first approximation—a number of my academic colleagues will start to quibble—and I will grant them their quibble, but factually it is true, but there is no free lunch out there. In other words, if everybody decided to invest in equities and nobody in debt, than the rate of return of equities would fall.

Mr. OXLEY. Well, do you like the idea or are you enchanted with the idea of giving individuals a choice of risk much like the Thrift Retirement System?

Mr. GREENSPAN. Yes, Mr. Chairman, I have always been in favor of some form of privatization because I believe that it is easier to raise the national savings rate through a private system than through a government system. The issue is not the form of the savings or the instruments that are involved, but the availability of a significant increase in savings to fund a necessary capital investment which will be required, because the demographics of our society are inexorably going to change in a manner, which means that there are going to be significantly more retirees to workers, and one should always conceive of all retirement systems, including Social Security, in terms of their physical characteristics. In other words, are enough goods and services being produced to supply both the retirees—whose numbers are going to be increasing very dramatically—and, the workers?

It is very easy to shift resources from workers to retirees and always make retirees whole. The question is—you cannot do that without impacting on workers unless the total pie increases. The only way to increase the total pie is to increase activity.

Mr. OXLEY. Thank you, Mr. Chairman.

My time has expired. The gentleman from New York, Mr. Towns.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Mr. Greenspan, in your testimony, you indicated that it may not be possible to insulate the trust fund from political pressure. Why do you feel so strongly about that?

Mr. GREENSPAN. I guess, Congressman, because I have been around this town for a very long period of time.

And, I work for individual members of the governing class who would have few compunctions in moving in that direction. And, I would be most concerned about it. I must say that Congressman Markey's bill goes a long way to trying to get to resolve that problem—and I must say to you, it is a commendable effort. I just find that there is something fundamental about the process which is very difficult to get around. But, frankly, my most important concern is that I don't think investing equities in the Social Security Trust Fund does anything for the retirement system as a whole. It is a shuffling of claims and doesn't increase the real resources. If it did, I guess one could argue it is worth taking the risk, the political risk, of what might happen. But I can't see what the benefits are and, therefore, I do not deny that we can probably construct probably a very formidable barrier to prevent political interference. I don't think at the end of the day it is feasible without a constitutional amendment. But I don't see what we are doing it for if there is no real benefit to retirees.

Mr. TOWNS. Let me put it this way: If investment in the Social Security Trust Fund in equities will do little to improve the overall ability of this Nation to meet our future retirement needs, what investment policy changes should we be making in order to meet the retirement needs of the 21st century?

Mr. GREENSPAN. Congressman, I would say anything which does one of two things: increases the amount of national savings or increases the efficiency of the capital stock which that savings is invested in. Both of those will contribute to real resources.

The reason I would be terribly concerned about our current situation is that we have gotten along exceptionally well since the end of World War II in funding retirement plans and basically making retirees reasonably well off—to whatever extent that can be. It has largely been the consequence of workers, either directly or indirectly, either allocating part of what they produce or claims that were built up from previous retirees for private pension funds. That is about to change. That is largely because population is about to become dramatically less employed as we move a big bulk in the population from the workforce where it is producing goods and services to the retirement community where it is consuming them. And, that is something we cannot change, short of a major increase in immigration. And, I don't sense in the Congress any inclination in that direction.

So, the fundamental issue is, no matter what we do, whether it is in the private sector or in Social Security, it is essential that we increase the aggregate amount of goods and services. That, in my judgment, is only feasible through increasing the rate of return on capital and/or increasing the savings which are invested in that capital.

Mr. OXLEY. The gentleman's time has expired.

Mr. TOWNS. Thank you much, Mr. Chairman.

Mr. OXLEY. The Chair now recognizes the gentlewoman from New Mexico, Mrs. Wilson.

Mrs. WILSON. Thank you, Chairman Greenspan I found your presentation most interesting and I have a couple of questions I have to preface my remarks by saying I didn't do very well in economics, so these questions may in some way seem simple to you. I'm still struggling a little bit with them.

Mr. GREENSPAN. Let me just say this, Congresswoman: This is an extraordinary difficult problem which the best economists have not quite figured how it all works yet, and what all the implications are. So I think that everyone is struggling on this issue.

Mrs. WILSON. You said in your testimony that if we transfer Social Security Trust Funds from U.S. Treasury securities to private debt, holders of the securities in the private sector must be induced to exchange them on net for U.S. Treasuries. I understand your point that that would be a no net increase in the overall retirement system since most of those equities are invested for retirement. But why must they be exchanged on that?

Mr. GREENSPAN. Well, that's an important question. The best way to visualize this is to think in terms how at any point in time—let's say the end of last year—that we have balance sheets for all individuals and businesses at a point in time when they owned various different types of assets. And you've got a Social Security Trust fund sitting up there and say on the December 31, there's a huge chunk of U.S. Special Treasury issues in the Social Security Trust Fund—which by law you have to convert into marketable instruments. You take the marketable instruments and you want to convert them into equities. And the question is, the only way to do that is to swap them with somebody else. Nothing else is happening at that point in time; it's an instantaneous change.

So what occurs is that you're trying to induce, within say 10 minutes, 15 minutes, 2 days, whatever the timeframe, a large block of holders of equities, private pension funds, insurance companies, individuals to swap the government debt from the Social Security Trust Fund for the equities that are held by private individuals. There is no other way to do that.

Mr. WILSON. To follow up on that, not with respect to the existing Social Security Trust Fund and the Treasuries that are in it, but for the revenue that comes in this year in Social Security taxes, which are not—maybe they are but—but they're not yet in Treasury notes, if there were individualized plans where that tax revenue was to be invested directly in the stock market, do you still have the same problem of no net increase or is that an increase in savings?

Mr. GREENSPAN. Maybe not. It depends on whether those actual taxes or—let us just assume that if 2 percent of the Social Security tax goes into a private account, the crucial issue is whether when you move that 2 percent, whether the aggregate savings of the economy is increased. If it is, then, the answer is yes, you do get an increased overall return. If not, then it's still a zero-sum gain.

The crucial question that must be answered gets down to that level, and it is not easy to determine. As I said previously, I think that I support such privatization because I do believe that process, ultimately at the end of the day will increase total national savings, and if it does, it is a plus; if it turns out not to, then it is a zero-sum gain.

Mr. OXLEY. The chairman's time has expired. The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

I like to begin first, Mr. Chairman—by the way, I hope the President named you for another 4 years and I hope that you say yes. You are a great man.

I want to clarify something here. If $400 billion, let us say, is put into individual accounts and invested, as opposed to $400 billion put into a centrally managed fund, say a Russell 2000, what is the difference in terms of the impact on the savings rate?

Mr. GREENSPAN. From what you have told me, Congressman, it's indeterminate.

Mr. MARKEY. Indeterminate?

Mr. GREENSPAN. Indeterminate; that in and of itself does not change savings.

Mr. MARKEY. Right, and that's my point. Whether it is——

Mr. GREENSPAN. Maybe the best way to respond to the question I think you are asking is that—take the extreme form of privatization where you would get all of the Social Security Trust Funds moving from the public sector to the private sector. And let us assume further that, because we need savings to fund the capital investment, we have to fully fund both systems because what fully funding means is you are creating claims on future assets which would be enough for future consumption of goods and services. And that is true whether public or private. The sole criterion I think is relevant here is which of the two systems has the higher probability of creating a larger amount of total national savings.

Mr. MARKEY. Okay.

Mr. GREENSPAN. And I would say that for reasons which I said before—I will be glad to go over it, but I think the private system looks better than the public.

Mr. MARKEY. So that becomes a debate then?

Mr. GREENSPAN. Correct.

Mr. MARKEY. Each have the potential of adding to private savings. So you contend if they are pooled over into individual retirement accounts, they are going to produce more income which will as a result——

Mr. GREENSPAN. No, no not more income, I think the capacity to have a fully funded private system is far higher—the probability is far higher than a public system where you have the possibilities of having to deal with very large surpluses which can be employed for other means. Now, one of the reasons which I felt the President is endeavoring to set aside 62 percent of the Social Security surplus is the judgment he is making is that it is politically infeasible to believe that we can keep that going. I happen to agree with him.

Mr. MARKEY. But this is the core of your notion—of your objection. The same amount of money invested by a central manager or by individuals is going to get the pretty much the same result, although I would argue that you would get more with a centrally managed because you would get rid of all those fees; you get rid of the administrative woes——

Mr. GREENSPAN. Well——

Mr. MARKEY. [continuing] and even with—and let us be honest, with the concerns of Arthur Levitt with regards to the percentage of Americans who really even understand the stock market, you wind up with, most likely, a huge percentage going into the hands of private managers.

So my concern is that, if we keep a constant number of dollars going into the private sector, then what I would ask you is, do you agree or disagree with the Advisory Council on Social Security, which has estimated that the administrative cost and fees of a privately managed individual account would average at least 1 percent per year and that would have to be taken right off the top of anything that an individual would receive?

Mr. GREENSPAN. It depends how it is invested. If it is individual stocks and it is done in the matter that is quite similar to say some of the mutual funds, the fees do rise to that level.

Mr. MARKEY. I appreciate that the Investment Company Institute report of last year, the average cost of an equity mutual fund was 1.49 percent a year and Lipper Analytical reported that the average charge for a no load equity mutual fund equal 1.21 percent of the amounts invested in the funds.

Mr. GREENSPAN. Sure, but the index funds can be managed for very significantly less. If you are asking me whether, in fact, the issue of the costs of management are an issue, the answer is, yes, they are. I think there are two elements to that. One is anything gained by the costs—in another words, does the investor get an additional service because they are paying more, and that is a question one has to make a judgment on. But there is no doubt that a small, relatively small change in costs of administration accumulated over a very significant period of time does add up to a lot of money, and I think that is a very relevant question to be put on the table.

Mr. OXLEY. The gentleman's time's expired. The gentleman from Louisiana.

Mr. TAUZIN. In the Chilean plan, in increasing the net savings rate, was the additional factor in their plan allowing their citizens that mandated a certain percentage to be invested—I think it was 10 percent of the income to be invested in the 14 or so plans. But the additional feature that allowed them to invest considerably more, I think as much as 15 percent more at tax-free savings in these equity plans, was that, in your opinion, designed to increase the net savings and, therefore, to achieve some the results you think, whatever option we choose ought to achieve?

Mr. GREENSPAN. My recollection was that the Chilean plan came out of what had previously been a chaotic——

Mr. TAUZIN. Yes——

Mr. GREENSPAN. [continuing] system and, in retrospect, it has been, clearly, one of the models which a number of emerging nations have been looking toward to replicate their own programs. The issue of equity investment per se does not necessarily change the savings rate; it is often a transfer between particular areas of the economy. But, I think the crucial question of what they called the recognition bonds, which essentially, in our vernacular would be, to take our contingent liabilities for benefits under current law and put them into an official obligation of the United States government——

Mr. TAUZIN. It is called gold bonds, I think.

Mr. GREENSPAN. In effect, they would be the equivalent of bonds that would be paid to individuals. Actually, all you need is a claim toward an annuity without even valuing the particular bonds. But that process apparently did increase the savings rate, as best I understand it in Chile——

Mr. TAUZIN. Quite significantly——

Mr. GREENSPAN. [continuing] their general view toward their ownership of their claim on their pension fund—apparently, according to some of my Chilean friends—was a badge of honor of some form, and they managed to create what was, in their view, quite significant success.

Mr. TAUZIN. But didn't also—the additional features, is what I am asking—whereby the Chilean worker was allowed to invest into his pension fund tax free far and above beyond the mandated investment requirements in addition to his gold bond, in addition to his 10 percent contribution—I think they were allowed to put 15 percent more. Wasn't that a very desirable feature in encouraging the private investor not only to invest wisely his Social Security deposit, but also additional monies into the system?

Mr. GREENSPAN. Yes, Congressman, I would assume what I can't prove, that the ability to invest in equities in that particular context probably did raise the savings rate. It's probably an exceptionally statistically difficult procedure to make that judgment definitively, but human nature being what it is, one must presume that it probably did have a positive effect.

Mr. TAUZIN. I know we don't have a lot of time, but you make a statement in your written reports. You said an efficient market pricing mechanism for equities has been the key element to a successful savings into investment in the past decade. You mention large investment in equities by the Social Security Trust Funds could impair that process. Could you elaborate, how might it impair the efficient price market pricing mechanism that currently exists in the market?

Mr. GREENSPAN. Well I think it could do so in a number of different ways. One of the major ways is the diversion of funds into economically targeted investments—which many State and local funds are required to do. But there's also the problem of whether, if the Social Security Trust Fund were to invest only in indexed stocks, for example, there would be fewer vehicles by which a number of venture capital type areas in our economy could be financed if Social Security became a very large player in the stock market. If it is small, obviously, my concern would be significantly less, but, as I said to earlier questions, it is not clear to me what the overall benefits are in the Social Security System of doing that. So I don't have a particular problem of making a judgment as to whether it's desirable or not.

Mr. OXLEY. The time of the gentleman has expired. The gentleman from Michigan.

Mr. STUPAK. Thank you, Mr. Chairman.

Mr. Greenspan, at the bottom of page 3 of your statement, you indicate that the large surpluses projected over the next 15 years, if they materialize, would significantly reduce the financial pressures created by our changing demographics. Whichever direction the Congress chooses to go, whether toward privatization or fuller funding of Social Security, augmenting our national savings rate has to be the main objective. The President's proposals on universal savings account, your opinion on that? I know that we're on Social Security, but I mean——

Mr. GREENSPAN. Yes, Congressman, as you know, the particular program has not been fully specified—I mean, other than certain general principles. I would apply the same principle I applied to everything else: If it increases savings, it is a plus; if it doesn't, it is a wash. I don't think at this particular stage we know enough about the details of the program to really make a sensible judgment. I will assume the President will be forthcoming at some point with full details on that, and I think it will be far easier to make some realistic judgment on that.

Mr. STUPAK. The basic premise on the USA accounts is that, as individuals save, the government would try to match—not necessarily match dollar for dollar—but at least contribute to that saving plan which would encourage hopefully more savings. That is a sound basic premise.

Mr. GREENSPAN. Well, the problem, Congressman, is we are not sure whether the savings put up by the individuals are new savings or merely diversions from previous savings into these new accounts. And, unless you can make that judgment I don't think you can conclude one way or the other whether or not the savings are augmented.

Mr. STUPAK. So it would have to be new assets going into the savings account?

Mr. GREENSPAN. Correct, it would have to be new savings. In other words, in a sense, a better way of looking at it is that less of one's income would be consumed, and that is tough to monitor.

Mr. STUPAK. Since you are not keen on this privatization or any investments here to fuller funding of Social Security over the next 15 years—we are talking again, if it materializes, $4.3 trillion surplus—how much of that surplus would have to go to Social Security for fuller funding?

Mr. GREENSPAN. Oh, that and considerably more because we are, as I indicated previously, underfunded in the Social Security Trust Fund and under current services, meaning the projection of our budgets under current law in respect to taxes and benefits, we end up with a shortfall which the Social Securities actuaries in the intermediate assumptions, as I indicated, declare is equal to 2.2 percent of the tax base. The shortfall implicit in that 2.2 percent is, indeed, the same order of magnitude as the $3 trillion-plus Social Security Trust Fund assets which we get to before they begin to liquidate. So it is already built into the underfunding issue, meaning there's a lot more to go.

Mr. STUPAK. While we spent our time on Social Security, would you not agree that Medicare should be addressed immediately, if not sooner?

Mr. GREENSPAN. Well, Medicare is a tougher problem, undoubtedly. If we can find a way to address Medicare in a sensible way, I would say it probably has priority over Social Security. But because Social Security is technically far easier to come to grips with than Medicare, my own judgment is that it is probably wise to put Social Security behind us and then try to focus more closely on Medicare, which is so heavily involved in forecasts of technology which we don't have, in the same sense in making an evaluation of the Social Security System.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Arizona, Mr. Shadegg.

Mr. SHADEGG. If I understand your testimony, Mr. Greenspan, you have indicated that simply shifting from the current investment by Social Security in debt instruments of the Federal Government to equity instruments in the private market in it of itself will not enhance return for the overall investment portfolio, the retirement investment portfolio of the Nation, is that correct?

Mr. GREENSPAN. That is correct, yes.

Mr. SHADEGG. And I presume from that, then, it is also true that that benefit will not be achieved merely by allowing individuals to invest in the private market, or am I mistaken about that? That is, creating individual retirement accounts with some of the monies flowing into the Social Security won't solve the problem either, is that right?

Mr. GREENSPAN. Unless you increase the savings rate in the process, the answer is, yes, it doesn't.

Mr. SHADEGG. And I believe what my colleague, Mr. Tauzin, was trying to focus on, the fact that it would at least appear, or can be argued, that in some of the countries where they have gone the private investment route, allowing individual investment in the private market has spurred a further savings—at least that was what he was positing—thereby enhancing the overall investment in retirement funds and boosting the economy.

Mr. GREENSPAN. Yes, a number of the particular programs to move toward privatization actually mandate additional savings above and beyond the Social Security taxes, and one must presume that, in doing that, you do increase the savings rate in the process.

Mr. SHADEGG. One of the things we can do to inject further savings in retirement or further private investment, the savings rate overall, would be tax incentives to achieve that goal?

Mr. GREENSPAN. Well, there are lots of different ways of doing it. One way, as I indicated earlier, is if you believe, as I do, that it is far easier to get full funding through a private system than a public system, now merely shifting funds, trust funds, and benefits, and in fact receipts from the Social Security System to the private system, will increase the national savings. But it is not the fact that there is something magical about equities or debt; it is wholly a question of what happens when the transfers occur. Here, if one could argue that you could fully fund Social Security, then the argument that you get superior savings in the private sector I think would fail.

Mr. SHADEGG. Let me turn to another aspect. You said that you weren't confident that any investment scheme which would have the government invest in the private market could be protected without a constitutional amendment, and I share that concern. But let me ask you a different concern. If we simply statutorily prescribe that government is now going to invest, as the President has proposed, a portion of the Social Security surplus into the private market, in equities instead of government debt, don't we run a very real risk that the moment the current surpluses disappear—say we were to hit a steep economic downturn—wouldn't there be a grave danger, absent a constitutional amendment restructuring the system, that the government would simply repeal what it had done and stop investing those monies in that surplus in the private market and, indeed, begin to spend in the current consumption as we, in fact, have done, to date?

Mr. GREENSPAN. Well, Congressman, I think that's the real issue; that is, we have been living in a period in the last 7 or 8 years where things have been going rather well. Both of these laws appear to have been repealed.

Mr. SHADEGG. Let us hope it is permanent.

Mr. GREENSPAN. All the things that could have gone wrong haven't. It is perhaps difficult to remember what it is like when things go bad. I think right now, for example, if Congressman Markey's bill would have been put through and your fund would be created, my judgment is that it would probably work for a while. I don't see any particular pressure that would exert. The real issue comes when things go wrong. When you are running a big deficit, you have caps on expenditures; you have all sorts of claims on resources. Then all you need is 51 percent of the Congress, and the President's signature, and it changes everything.

Mr. SHADEGG. I see my time has expired. Let me just simply conclude. I think that is the essence of the problem and that we have, historically, proven that if government can get its hands on it, it will, in fact, spend the money. Therefore, the advantage of privatizing this money is to create in the public the belief, or the sense, or the actuality of ownership, making it, therefore, more difficult—hopefully impossible—for the government to reach out and steal that money back. I would be interested in your comment on that point.

Mr. SHADEGG. I think that is the correct argument.

Mr. OXLEY. The gentleman's time has expired. The gentlelady from Colorado.

Ms. DEGETTE. Thank you, Mr. Chairman.

Chairman Greenspan, one thing that we have been talking a lot about on this subcommittee is the extraordinary move that the baby-boom generation, and even our parents, have made to invest their retirement money in the stock market. Average folks are investing in the market more than any time in the past. For example, right now about 4 percent of the market is held by Fidelity funds—a fund that I invest in and probably so a lot of other members of this committee.

One thing that you have talked about today is the effect that government investment of a portion of the Social Security Trust Fund in the stock market will have on the market. Could you comment on what you think would happen once the baby-boomers start to retire drawing off the Social Security Trust Fund, which would hold about 4 percent of the market, and, at the same time, moving their own investments out of equities—as our financial advisors tell us we should. What happens when you have the convergence of these events?

Mr. GREENSPAN. That is an interesting issue. A lot of people have raised this question. If you buildup equities in the Social Security Trust Fund and you have to liquidate the fund as you get to the very large numbers of retirees, is it a significant negative on the stock market? I suspect not. Let me say why.

Ultimately, the value of equities really reflects the values of the companies, the real assets, that are producing goods and services and earnings. And, who happens to own the claims should not have a significant effect on the value of those claims. I don't deny that in the short run, if you get a substantial degree of liquidation of equities, that the prices will go down, but they are unlikely to stay down because they are not ultimately determined—let me put it another way. The value of the corporation should be independent of who owns it, and merely shifting around who owns it shouldn't effectively change its value. It will in the short run, because of a lot of technical reasons, but there is no reason to expect that to be the case over the long run.

Ms. DEGETTE. And you believe that would be true even with a fairly extensive liquidation as we would see in people——

Mr. GREENSPAN. I am sorry, could you move your microphone a little bit closer?

Ms. DEGETTE. I am sorry. And, you would think that that would be true—the kind of extensive liquidation that we would see with both the Social Security Trust Fund beginning to liquidate because of the increasing people retiring and at the same time, people shifting their private investments away from equity?

Mr. GREENSPAN. I would think so. I mean, if the proposition which I stipulated is correct, then the answer is obviously it would have no effect. I am not saying I'm 100 percent accurate but I have a suspicion that I'm more than 90 percent accurate. So, there may be some effects, but it can't be large.

Ms. DEGETTE. Now, I would like to follow up on the issue that my colleague from Arizona was talking about. Couldn't Congress just go in and change the law, if they pass the Markey law or any other law, couldn't they just go in and do that? Well, we were sitting back here talking about how Congress could repeal the independence of the Federal Reserve Board—for example, we threaten to, with great regularity around here. Practically speaking, if we set up these higher laws, as we are discussing, do you think in 30 years—or however long it would be—that Congress would practically begin to repeal that?

Mr. GREENSPAN. Well, let's remember one thing. And, there are a lot of issues here about whether the Federal Reserve is being politically pressured or the like. I will give you a very strange answer. I think we should be. Because we live in a democratic society and Congress has delegated to us the authorities which we have. And, I think it would be inappropriate for Congress not to be telling us, or giving their judgments, as to what they think we ought to do, and we, indeed, listen. And, I must tell you, on occasion, I do hear things which do affect how we deliberate. And, I think that is right. But we listen to everybody, and I think that the presumption that we should be blocking off Congress from either the Federal Reserve or this new organization, I think is a mistake. This is a democracy. This is an appropriate structure of the way we function.

I am less concerned that we will create inappropriate monetary policies than I am that very specific, simple pieces of legislation will emerge like do not invest any of these funds in industry X. If industry X is in trouble politically, or otherwise, you will get an overwhelming vote here on that issue. It is an easy vote in a sense. It is not an easy vote to have significant inhibition on the Nation's central bank. So, I do think there are orders of magnitude which are different.

Mr. OXLEY. The gentlewoman's time has expired. The gentleman from Iowa Dr. Ganske.

Mr. GANSKE. Thank you, Mr. Chairman.

Mr. Greenspan, you're good with numbers. I want to ask you a question about the budget as it relates to Social Security, and it goes back to my opening statement because I'm not the only one who has been confused by the President's numbers. Many economists have said this is a very confusing and complicated statement on the budget as it relates to Social Security. So let me just go through some of these numbers again.

The President's budget—maybe you can enlighten me on how these numbers work out. The President's budget forecasts a total of $4.5 trillion over the next 15 years. Now of this surplus, $2.7 trillion, you could say, already belongs to the Social Security Trust Fund because it is what is coming from the excess payroll tax. With the remaining $1.8 trillion, the President then proposes $1.7 trillion in new spending. But then the President also says he wants to set aside 62 percent of the $4.5 trillion surplus, or $2.8 trillion to extend the Trust Fund solvency.

So, it looks to me like the President's budget is making commitments and promises of $2.8 trillion, plus $1.7 trillion, plus $2.7 trillion, for a total of $7.2 trillion, but you only started out with $4.5 trillion. Now can you comment on this or clarify this for me?

Mr. GREENSPAN. Yes, I think that there has been an unfortunate set of, I will say, bookkeeping going on here which—let me see if I can clarify exactly what is happening. The Social Security Trust Fund, which is the difference between receipts and outlays plus interest, is virtually all of the so-called off-budget part of the unified budget. The postal system is the other thing which is small. If you think in terms of the unified budget surplus being comprised of two elements which are additive, one is the Social Security Trust Fund and all other which we are now calling on budget. What is happening is that if you leave the total system to run, under current law, you will end up with—let me just say, at the moment, we have a very small deficit on budget and a very large surplus in the Social Security Trust Funds, so that the total unified budget surplus is very close to the Social Security surplus at this particular point.

If you project the current services budget out into the next 10 years or so, what happens is the Social Security Trust Fund remains large and growing, but the on budget small deficit turns to surplus and becomes very substantial, so that we have a surplus cumulatively over the next 10 or 15 years, which is comprised of two parts, one the total Social Security surplus and the on-budget surplus.

Mr. GANSKE. Is that taking into account sticking with the 1997 Balanced Budget Act, the caps?

Mr. GREENSPAN. Yes, it is.

Mr. GANSKE. Okay, so if you break those caps, you don't have that?

Mr. GREENSPAN. Absolutely. I'm just talking about current law and current practice, actually, but it is certainly the case that all caps are in place in that particular projection. The President makes a judgment that it is not possible to maintain that large unified budget surplus politically, and so he says let us mandate that part of the surplus will be locked in; the other is not. And he has effectively moved general revenues, which is the on-budget part, into the Social Security Trust Fund, in addition.

If you would like, Congressman, what I may get for you, rather than try to do this orally, is to give you a set of tables which reconciles precisely the numbers that you are working with on this. The bottom line is that, if you look at what the program is, it is dipping into some of the on-budget surplus and allocating it to Social Security along with the existing Social Security Trust Fund surplus, these general revenue transfers augment the Social Security System, and move it from the year 2032, which is where we would expect the Social Security Trust Fund to go bust, out to 2049. The additional transfers which occur as a consequence of moving equity income in there move you from 2049 to 2055, and the President has indicated that he would like additional additions to the Social Security Trust Fund coming from agreements to either reduce benefits or increase taxes for the remainder of it.

[The following information was received for the record:]

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D.C.
March 17, 1999

The Honorable GREG GANSKE
House of Representatives
Washington, D.C. 20515

DEAR CONGRESSMAN: During the March 3 hearing on the market impact of the President's social security proposal, we discussed whether the Administration was "double-counting" the surpluses. As I stated then, the Administration's budget accounting is quite complicated, and it has led to a great deal of confusion. Fundamentally, however, "double-counting" is a misnomer. I enclose a short memo that attempts to clarify the issue, as promised.

Sincerely,

ALAN GREENSPAN
Chairman

Enclosure

THE ADMINISTRATION'S BUDGET

1. The direct effect of the Administration's budget on national saving depends only on the **unified** budget balances. The attached table provides an estimate of the budget arithmetic.[1] For simplicity of presentation, the table excludes the effects of investing the trust fund assets in equities.

- The current services unified budget surpluses total $4.9 trillion over the next 15 years.
- The Administration proposes spending $1.4 trillion on USA accounts, defense, and other programs, leaving a net unified surplus of $3.5 trillion.

2. The Administration has also proposed transferring $2.8 trillion to the social security trust fund, and $0.7 trillion to the Medicare trust fund.

- These transfers **do not** represent increased spending, and have no direct effect on the unified budget balance or on national saving.
- Transfers to the social security trust fund reduce the on-budget surplus but increase the off-budget surplus; transfers to the Medicare trust fund have no effect on either balance, because the Medicare trust fund is on-budget.
- The transfers can be viewed as an earmarking of general revenues for social security and Medicare. As long as promised benefits are unchanged, the transfers simply specify the sources of funds that will be used to finance the benefits.

3. The so-called "double counting" concerns stem from the fact that the proposed transfers to the social security trust fund are larger than the available on-budget surpluses.

- Under the Administration's budget, the on-budget balances are in deficit over the 15-year horizon. But the on-budget deficits are more than made up for by off-budget surpluses.
- The transfers to the trust funds have no direct economic effects. However, if they affect political outcomes—for example, if the transfers reduce the likelihood of large spending increases or tax cuts or influence other reforms of social security or Medicare—then the transfers may have indirect economic effects.

[1] The Administration has not released estimates of the surpluses under their social security proposal.

Budget Projections for 2000-2014

(Trillions of dollars, fiscal years)

	Unified budget balance	Off-budget balance	On-budget balance
Current services baseline (OMB)	**4.9**	**2.7**	**2.2**
Administration budget			
Spending on USAs	-.5		-.5
Spending on defense and other	-.5		-.5
Increased debt service	-.4		-.4
New Spending	-1.4		-1.4
Transfer to social security trust fund	0	+2.8	-2.8
Estimated interest on trust fund balance	0	+1.0	-1.0
Estimated new budget balance	**3.5**	**6.5**	**-3.0**

Mr. GANSKE. Mr. Chairman, I ask unanimous consent for 2 additional minutes.

Mr. OXLEY. Would 1 additional minute be——

Mr. GANSKE. One additional minute.

Mr. OXLEY. No objection.

Mr. GANSKE. Let me see if I can summarize what I think you are saying. Okay. Of that $4.5 trillion, $2.7 is Social Security.

Mr. GREENSPAN. I think that is correct.

Mr. GANSKE. Okay. So, in a sense, the President says, well, what we are going to do is we are going to take 62 percent of that total surplus——

Mr. GREENSPAN. Actually, he is taking 62 percent of the unified budget surplus, which is where——

Mr. GANSKE. I am sorry, 62 percent of the unified budget surplus. Which happens to work out to be close to what the Social Security component would be—$2.7 versus $2.8, something like that. So, in a sense, you are taking that Social Security part, you are going to save what should have been saved for Social Security. But then what he is saying—correct me if I am wrong on this—is that we are going to, then, spend everything else that comes in because he has spending of $1.7 trillion in his budget and that, then is, basically the difference between the $2.7 and the $4.5?

Mr. GREENSPAN. Well, let me put it this way——

Mr. GANSKE. Is that accurate?

Mr. GREENSPAN. I hesitate to answer because I want to be sure that all the numbers—I don't have the numbers in front of me to put it together, but essentially something like that is happening. It is not, as some people are saying, double-counting. It is not that. If you think in terms——

Mr. GANSKE. But it would be accurate to say that, under the President's budget, that any other surplus that is projected there is accounted for by spending?

Mr. GREENSPAN. Well, it is not spending; it is a movement of funds out of general revenues. Now, it is not the same thing as spending. What it is, basically, is to reduce the on-budget surplus, and take that block of funds and add it to the Social Security Trust Fund. Remember that since neither benefits, nor taxes, are changed, the only way that you can move from the year 2032 to the year 2049 by building up Social Security Trust Fund is to effectively take it out of the on-budget general revenues.

Mr. OXLEY. The gentleman's time has expired.

The gentleman from Wisconsin, Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Just to continue this line of thought, from your perspective, the dipping into the general fund, is that a solid idea or a bad idea?

Mr. GREENSPAN. Well, it depends, as Congressman Markey said, in comparison to what? If you take the existing current services budget, you will end up with a higher unified budget surplus than is in the President's program. Basically, because there is some spending of the unified budget surplus. If you believe—and I suspect I would agree with the President on this—that it is unrealistic to believe that we will maintain the unified budget surplus that is projected under current law through tax cuts or spending, and if you believe, as I do, that savings are crucial, then anything which tries to maintain that surplus is a useful device.

I, personally, have been very uncomfortable about using general revenues in the Social Security System. Indeed, most Social Security professionals are concerned because they are worried about the discipline of the system and the fear of making it a welfare program. I would be more inclined, if you are going to adjust the system—as I said in earlier testimony, I would address the possibility of effectively examining: one, the benefit structure and, two, the CPI escalator issue, which Senator Moynihan has raised issues about, I think quite correctly.

So, it really comes down to a question of, what are the benefits and the costs of going in different directions? At root, the criterion which I would tend to use is what tends to increase the savings rate the most and what, basically, increases the capital assets in this economy the most, because that is what is going to be necessary to fund a very sharp increase in the ratio of retirees to workers.

Mr. BARRETT. Now I am even more confused, then. Because, you are saying if the three options are that this money, this unified surplus, that it would be unrealistic to think that it is going to stay there, that we would either spend it, have a tax cut, or put it into the Social Security Trust Fund, those seem to be, as Mr. Markey said, compared to what? Looking at those comparisons, which do you think is the best?

Mr. GREENSPAN. Well, if you told me that you could effectively function with that large unified budget surplus over the next 15 years and not either spend it or cut taxes from it, I would say that program is superior to the President's program.

Mr. BARRETT. I am telling you we can't.

Mr. GREENSPAN. Okay. You go back a step. If it turns out that you can save part of it, then that is desirable to do. If it turns out that you are going to spend it all, I would strongly support cutting taxes.

Mr. BARRETT. Just so I know your ranking——

Mr. GREENSPAN. My ranking is, surplus, do nothing. Keeping the largest surplus as possible would be my first ranking.

Mr. BARRETT. Okay, gotcha.

Mr. GREENSPAN. Reducing the government debt, I think would be very helpful in maintaining the economy and, more specifically, creating the savings for the assets to help the retirees.

Mr. BARRETT. So that is preferable to the tax cut?

Mr. GREENSPAN. That is preferable to a tax cut.

Mr. BARRETT. And, a tax cut is preferable to spending?

Mr. GREENSPAN. Correct.

Mr. BARRETT. Okay. I know I don't have much time——

Mr. GREENSPAN. That is my judgment, not anybody else's.

Mr. BARRETT. Okay. I understand. I think your judgment is pretty well respected, so that is why I wanted to have your judgment.

You recognize that this is—for young people, they are not happy with the system. How do we change the system to have young people have more confidence in this?

Mr. GREENSPAN. Well, Congressman, I think that we ought to be looking at the issue not of immediate privatization, but to remember that the younger people coming into the workforce right now have an expected rate-of-return into the Social Security System which is significantly below what they could probably get in virtually any private plan. The problem, as you know, if you begin to divert their funds to the private system, then their contribution to the benefits of the older workers is reduced and you are running into a terribly difficult problem of who finances that.

I, personally, think we could probably solve that problem by some form of recognition bond issue, which is a complex issue—I know the light is red and I can't get into it. But I would be very glad to send you a paper I presented to the Senate Budget Committee Task Force on Social Security in which this issue was raised. And, I hope it will explain what, I think, could conceivably be done.

[The following was received for the record:]

PREPARED STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM BEFORE THE TASK FORCE ON SOCIAL SECURITY, COMMITTEE ON THE BUDGET, UNITED STATES SENATE, NOVEMBER 20, 1997

I am pleased to appear here today to discuss one of our nation's most pressing challenges: putting social security's Old-Age and Survivors Insurance program on a sound financial footing for the twenty-first century. It has become conventional wisdom that the social security system, as currently constructed, will not be fully viable after the baby boom generation starts to retire. The most recent report by the social security trustees projected that the trust funds of the system will grow over approximately the next fifteen years. However, beginning in the year 2014, the annual expected costs of the Old-Age and Survivors Insurance program are projected to exceed annual earmarked tax receipts, and the subsequent deficits are projected to deplete the trust funds by the year 2031.

This imbalance in social security stems primarily from the fact that, until very recently, payments into the social security trust accounts by the average employee, plus employer contributions and interest earned, were inadequate to fund the total of retirement benefits. This has started to change. Under the most recent revisions to the law and presumably conservative economic and demographic assumptions, today's younger workers will pay social security taxes over their working years that appear sufficient, on average, to fund their benefits during retirement. However, the huge liability for current retirees, as well as for much of the work force closer to retirement, leaves the system as a whole badly underfunded.

This issue of funding underscores the critical elements in the forthcoming debate on social security reform, because it focuses on the core of any retirement system, private or public. Simply put, enough resources must be set aside over a lifetime of work to fund the excess of consumption over claims on production a retiree may enjoy. At the most rudimentary level, one could envision households saving by actually storing goods purchased during their working years for consumption during retirement. Even better, the resources that would have otherwise gone into the stored goods could be diverted to the production of new capital assets, which would, cumulatively, over a working lifetime, produce an even greater quantity of goods and services to be consumed in retirement. In the latter case, we would be getting more output per worker, our traditional measure of productivity, and a factor that is central in all calculations of long-term social security trust fund financing.

In sum, the bottom line in all retirement programs is the availability of real resources. The finance of any system is merely to facilitate the allocation of resources that fund retirement consumption of goods and services. Unless social security savings are increased by higher taxes (with negative consequences for growth) or reduced benefits, domestic savings must be augmented by greater private saving or surpluses in the rest of the government budget to ensure that there are enough overall savings to finance adequate productive capacity down the road to meet the consumption needs of *both* retirees and active workers.

The basic premise of our current largely pay-as-you-go social security system is that future productivity growth will be sufficient to supply promised retirement benefits for current workers. However, even supposing some acceleration in long-term productivity growth from recent experience, at existing rates of saving and capital investment, a pick-up in productivity growth large enough by itself to provide for impending benefits is problematic. Moreover, savings borrowed from abroad, our current account deficit, cannot be counted on indefinitely to bridge the gap between domestic investment and domestic savings.

Accordingly, short of a far more general reform of the system, there are a number of initiatives, at a minimum, that should be addressed. As I argued at length during the Social Security Commission deliberations of 1983, with only modest effect, some delaying of the age of eligibility for retirement benefits is becoming increasingly pressing. For example, adjusting the full-benefits retirement age further to keep pace with increases in life expectancy in a way that would keep the ratio of retirement years to expected life span approximately constant would significantly narrow the funding gap. Such an initiative would become easier to implement as fewer and fewer of our older citizens retire from physically arduous work. Hopefully, other modifications to social security, such as improved cost-of-living indexing, will be instituted.

There are a number of broader reform initiatives that, through the process of privatization, could increase domestic saving rates. Given the considerable stakes involved, these are clearly worthy of intensive evaluation. Perhaps the strongest argument for privatization is that replacing the current underfunded system with a fully funded one could boost domestic saving. But, we must remember that it is because privatization plans might increase savings that they are potentially viable, not because of their particular form of financing.

Moving toward a privatized defined-contribution plan would, by definition, convert our social security system into a fully funded plan. But, the same issues and questions remain as under the current system. What level of retirement income would be viewed as adequate, and should required contributions to private accounts (and savings) be increased to meet this level? Is there an alternative to forced savings to raise the level of contributions to the private funds?

Finally, if individuals did invest a portion of their accounts in equities and other private securities, thereby receiving higher rates of return and enhancing their social security retirement income, what would be the effect on non-social security investments? As I have argued elsewhere,[1] unless national saving increases, shifting social security trust funds to private securities, while likely increasing income in the social security system, will, to a first approximation, reduce non social-security retirement income to an offsetting degree. Without an increase in the savings flow, private pension and insurance funds, among other holders of private securities, presumably would be induced to sell higher-yielding stocks and private bonds to the social security retirement funds in exchange for lower-yielding U.S. Treasuries. This could translate into higher premiums for life insurance, and lower returns on other defined-contribution retirement plans. This would not be an improvement to our overall retirement system.

Furthermore, the potential consequences of moving social security to a system that features private retirement accounts need to be considered carefully. Any move toward privatization will confront the problem of how to finance previously promised benefits. That would presumably involve making the implicit accrued unfunded liability of the current social security system to beneficiaries explicit. For example, participants at the time of privatization could each receive a non-marketable certificate that confirmed irrevocably the obligations of the U.S. Government to pay a real

[1] See my remarks at the Abraham Lincoln Award Ceremony of the Union League of Philadelphia, December 6, 1996.

annuity at retirement, indexed to changes in the cost of living. The amount of that annuity would reflect the benefits accrued through the date of privatization.[2]

Under our current system, social security beneficiaries technically do not have an irrevocable claim to current levels of promised future benefits because legislative actions can lower future benefits. In contrast, the explicit liability of federal government debt to the public is essentially irrevocable. A critical consideration for the privatization of social security is how financial markets are factoring in the implicit unfunded liability of the current system in setting long-term interest rates.

If markets perceive that this liability has the same status as explicit federal debt, then one must presume that interest rates have already fully adjusted to the implicit contingent liability. However, if markets have not fully accounted for this implicit liability, then making it explicit could lead to higher interest rates for U.S. government debt.

For any level of real annuity at retirement, the corresponding current value of recognition certificates would depend on a number of technical assumptions. These assumptions have no impact on the real payouts from the retirement annuities but determine the current notional value of recognition certificates, which is useful for making broad economic comparisons. For example, factoring in a 2 percent real annual rate of discount and including other technical assumptions, the value of recognition certificates the U.S. government would need to issue to ensure that all currently accrued legislated future benefits are paid would be roughly $9½ trillion. Alternatively, at a 1 percent real rate, the value would be roughly $12 trillion, and at a 6 percent real rate, the value would be about $4½ trillion.[3] Because, under a wide range of assumptions, the magnitude of this liability remains very large relative to the current outstanding federal debt to the public—$3½ trillion—the market adjustment could be substantial.

There is reason to suspect, however, that if such a liability is made explicit in a mariner similar to the transition procedure in Chile, each dollar of new liability will weigh far less on financial markets than a dollar of current public debt. In the case of the Chilean pension reform, a significant portion of the implicit liability of their old system was made explicit at the initiation of the new pension system by the issuance of "recognition bonds" that were deposited in workers' individual accounts. These bonds were initially nonmarketable, indexed for price inflation, and yielded a fixed real return on a specified face value. In Chile, the liquidation of these bonds generally occurs only after a worker retires and the proceeds from the bonds are required to be paid in the form of an annuity or through programmed partial withdrawals. These bonds have been viewed as a different instrument from other forms of public debt, and it is likely that if an instrument such as recognition certificates were issued here, it also would be viewed as distinct from fully-liquid marketable public debt.

In effect, under privatization, the obligations of social security would be transferred from an implicit government account to millions of private individual accounts. Retirement needs would be funded first by the conversion of recognition certificates, and later by withdrawals from private defined contribution funds. The outstanding certificates would accordingly decline with time, and finally be paid off some decades in the future. But if benefits and contributions do not change, national savings are only being transferred from the federal government account to that of households and are not increased in the process. It is only if contributions or private saving increases that household and national saving increases.

The transfer of savings from public to private accounts would affect the unified budget balance of the U.S. government, although precisely how that balance would be affected would depend on the exact budgetary accounting treatment adopted for recognition certificates. Certainly, with immediate and full privatization, the ongoing annual unified budget balance would decline by at least the amount of the social security surplus: As payroll taxes were diverted from public coffers to private accounts, they would no longer count as tax revenues; similarly, payments of social security benefits would not count as outlays.

The issuance of recognition certificates under current accounting rules presumably would also increase outlays and the deficit by the value of the certificates at

[2] Calculating the accrued benefits would require an estimate of future national real wage growth.

[3] Note that these estimates of the value of the accrued liability differ in concept from the $3 trillion official OASDI unfunded liability. That number represents the difference between expected future tax payments and future benefits over a 75-year horizon, and also includes the unfunded liability of the disability program. Even if the assets in the social security trust fund were to be increased by the $3 trillion, the social security system would still not be in balance over the long-term (i.e., in perpetuity).

the time of issuance. Exactly how much the deficit would be affected in the initial year, and how much in subsequent years, would depend on how the certificates were structured and on bookkeeping conventions.[4] However, the basic effects of privatization on the budget deficit are clear—the implicit liabilities of the social security system would start to appear on our balance sheets now, rather than when the baby boomers retire.

It is an open, but crucial, question as to how financial markets would respond to a change of the magnitude contemplated by immediate full privatization. Before any such move is made, a thorough examination of the risks and benefits to the financial markets would be wise. The key issues that will affect the economy are (1) the change from the implicit liability of the current system to one of an irrevocable obligation to pay and (2) the magnitude of changes in national saving and the level of productivity-spurring investment. The budget bookkeeping on how privatization is recorded has little significance.

An alternative to what is clearly a "big bang" one-shot transition, in which privatization occurs immediately for all, is a gradual transition where, for example, only younger workers are accorded recognition certificates, and are required to fund the remainder of their retirement needs through defined contribution plans. Over the years, ever older groups would be included in the new system. During the transition, two systems would operate in parallel. Such a transition would involve smaller immediate increases in recognition certificates (and in the unified budget deficit) and smaller accompanying market risks, but would have larger effects in subsequent years, as tax revenues from the younger groups would be diverted as contributions to private accounts, whereas all social security benefits to retirees would still be counted as government outlays.[5] Thus, if there is a unified budget surplus before the transition, it will be reduced or turned to a deficit at least to the extent of the loss in tax revenues. In effect, social security benefits will be increasingly financed with "general revenues" for a time. Should this be the direction that the Congress decides to move, containment of spending outside of social security doubtless would be necessary to add assurances to the market.

Ultimately, of course, even under a gradual transition, the system would be almost fully privatized. I say almost because I presume Congress would provide some form of assistance to those who through investment imprudence or unforeseen events had retirement benefits below a certain level perceived as an absolute minimum. Needless to say such a new entitlement would have to be rigorously delimited because political pressures to increase it could be overwhelming.

Despite all of these complications, in the broader scheme of things, the types of changes that will be required to restore fiscal balance to our social security accounts are significant but manageable. More important, most entail changes that are less unsettling if they are enacted soon, even if their effects are significantly delayed, rather than waiting five or ten years or longer for legislation. We owe it to those who will retire after the turn of the century to be given sufficient advance notice to make what alterations in retirement planning may be required. If we procrastinate too long, the adjustments could be truly wrenching. Our senior citizens, both current and future, deserve better.

Mr. BARRETT. I would appreciate that. Thank you.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Oklahoma, Mr. Largent.

Mr. LARGENT. Mr. Greenspan, is Social Security figured into the national savings rate?

Mr. GREENSPAN. The Social Security Trust Fund is. Let me put it to you in specific terms. The unified budget surplus, or, more exactly, the unified budget, is part of the national savings to the ex-

[4] For example, if the certificates could be treated as non-interest bearing, then the notional face value of the certificates would be quite large; their issuance would lead to a one-time spike in the deficit, but the certificates would not affect the deficit in future years.

Alternatively, if the certificates were accorded an imputed interest rate for budget accounting, while the immediate effect would be to record a lower deficit, the unified balance of the U.S. government would increase in subsequent years by interest accruing on the certificates. Finally, should the recognition certificates be kept separate from the unified budget, the unified deficit would only be affected by the loss of the social security surplus.

[5] The cumulative total effect of privatization on the unified budget is approximately the same whether the privatization is immediate or phased in. Immediate privatization results in bigger up-front deficits.

tent that the Social Security Trust Fund increases; to the extent that there is a surplus in it, that is part of the national savings.

Mr. LARGENT. So, when a national savings rate is figured on a per-capita basis—and, we have seen figures—they figure in the Social Security Trust Fund and any surplus to it?

Mr. GREENSPAN. I don't know what specific numbers are referred to here, but there is no doubt that the contribution, not the level of the trust fund, but the net annual surplus, is added to the net household savings, plus business savings, plus non-Social Security savings, to get the total national savings.

Mr. LARGENT. Okay, that was my question. Mr. Greenspan: What is the relationship between tax rates and national savings rates?

Mr. GREENSPAN. In an accounting sense, none, but in an economic sense, one must presume that if you have very high tax rates in an economy, its ability to create capital wealth and standards of living will be significantly diminished. So, one can probably argue that in economic terms they are very likely inverse.

Mr. LARGENT. Okay. So, one of the things you hit pretty hard in your testimony is figuring out a way to increase national savings. And, so, according to your last response, your last answer, one way to increase national savings would be to decrease tax rates.

Mr. GREENSPAN. Well, I can conceive of a scenario in which that would be true, yes.

Mr. LARGENT. Okay. One other thing that I wanted to get a comment on—this is the last thing—is that I think that one of the fundamental and significant differences between privatizing Social Security to individuals versus privatizing Social Security by simply allowing the government to invest assets in equities, that one of the real significant differences between those two forms of privatizing Social Security, if you will, is the issue of ownership—and, one that we hear a lot about from our constituents—meaning: when my husband died, the assets that he had in Social Security weren't passed on to his children, versus, when an individual has the opportunity to own an account and invest it in equities—like we do with our Federal program—those assets do pass on to your heirs. Could you comment on that?

Mr. GREENSPAN. Congressman, I think it is a good point that you are making. In fact, there is a little confusion about what constitutes Social Security wealth. Social Security is essentially a defined-benefit program in which the government, by law, is obligated to pay certain amounts to individuals, wholly independently of what is earned in the Social Security Trust Fund. Now, to be sure, they try to make relationships between them, but the specific annuity in Social Security that an individual potential retiree has is the claim against the government, not what the government trust fund earns or doesn't earn.

So, in that sense, there are no ownership rights whatsoever in the equities by Social Security recipients. It is merely a funding means, and the funding—the relationship between Social Security benefits and what is in the trust fund is very, very loose, to say the least. While there is a superficial resemblance between investing in equities, whether it is public or private, it is in fact night and day. And, I am strongly supportive of investing in equities in the private system, but not in the public system, on the basis of the various judgments that I have made.

Mr. OXLEY. The gentleman's time has expired. The gentleman from Florida, Mr. Deutsch.

Mr. DEUTSCH. Thank you, Mr. Chairman.

Thank you, Mr. Greenspan. If I can maybe follow up on Congressman Largent's questions, the distinction between some type of privatization versus the President's proposal versus some of the Republican proposals, and the difference in terms of private accounts versus this sort of public investing, could you respond how you would expect those two systems to work differently in a significant market downturn situation?

Mr. GREENSPAN. I am sorry, could you repeat that again?

Mr. DEUTSCH. In the difference between the private individual account versus the public investment, what the response would be in a market downturn situation?

Mr. GREENSPAN. Yes. Are we assuming that the public account has got equities in them?

Mr. DEUTSCH. That is correct.

Mr. GREENSPAN. In the private system, it is going to depend, to a large extent, on to what extent you have a safety net in there. All the private programs of which I am aware have some element of minimum guaranteed benefit of some form or another. In the public sector, as I said before, the relationship between what is in the trust fund in Social Security and what the benefits are is very loose.

I can conceive—it is tough, but I can conceive—of a case in which you would have a severe decline in equity holdings in the Social Security Trust Fund, and it would create some pressure to somehow alter Social Security benefits. I think that is extraordinarily unlikely, but I will admit to the fact that it is possible.

In the private sector, obviously, if a decline in equities occurs—there is a loss to the retiree, with the exception of the guarantee part of the program. So, in one sense, I would almost say it is almost irrelevant to the Social Security Trust Fund; it is not irrelevant, obviously, to the private sector.

Mr. DEUTSCH. Again, I think what is clear, though, in the proposal that the President has made is that those potential downturns—i.e., the 1974 situation—in a sense, both past generations and future generations could level that. I see a scenario where, in the private system, if we allow people to invest privately in individual accounts, that you have a scenario that someone turns 65 in 1974—assuming that the system existed you know, let us say, for 40 years up to that point—wanting to retire at 65 in 1974, for a reduction of 40 percent in a total equity, or an index account at that point. What happens to that person? Again, how much can a safety net make up for that 40 percent decline?

Mr. GREENSPAN. Well, I think the way you solve that is, basically, I would assume, as you move closer and closer to retirement, you move to less and less risky assets. In other words, if you have everything in equities, if you have everything in Internet stocks, I mean, you are in real trouble. But it is a question of how you manage the potential portfolio.

But let me say this: If you are going to have a small amount of equity in the Social Security Trust Fund, its purpose has got nothing to do with guaranteeing benefits.

Mr. DEUTSCH. Right.

Mr. GREENSPAN. The benefits are guaranteed by law. And, what they will do is, essentially, increase or decrease the unified budget surplus or deficit of the Federal Government. In other words, if there is a large loss in equities held by the Social Security Trust Fund, the general taxpayer is the one who will field the cost.

Mr. DEUTSCH. Let me just, in my last question—obviously, we are about to have a vote; I think they want to finish up—related to your statement about Internet stock, and just market conditions, just in terms of the potential in the market in the big picture—and, obviously, it relates to Social Security, ultimately—the fact that we have this phenomena of incredible amounts of the market being day traded and margins of up to 10 percent margins in some of the way that they are able to do their margining, what is your concern about that in terms of market conditions overall? What are we doing to try to correct the potential disaster that might be out there?

Mr. GREENSPAN. Congressman, if you wouldn't mind, I am going to fudge on that question. I do it generally, but I usually don't ask permission.

It is complex answer, and we just don't have the time, but if you like, I would be very glad to discuss it with you on the phone if you want to give me a call.

Mr. DEUTSCH. Okay.

Mr. OXLEY. The gentleman's time has expired. The gentleman from California.

Mr. BILBRAY. Thank you. Mr. Greenspan, I want to really commend you on your testimony today, I appreciate it.

I want to clarify, to make sure we are talking apples and oranges here. You made a reference to the fact that you felt that if there was a choice between spending and tax cuts, if that was a choice, rather than paying down the debt, you would recommend tax cuts.

Mr. GREENSPAN. Absolutely.

Mr. BILBRAY. You are speaking plain English here. It if was a difference between investments and tax cuts——

Mr. GREENSPAN. I am sorry, investment where?

Mr. BILBRAY. Well, I am just saying that in Washington right now spending is now tagged as investments.

Mr. GREENSPAN. Oh, that. Oh, okay. This is a cost-benefit analysis. I can conceive it—I was asked in the Senate the other day precisely that question on an issue of education on certain sorts of things. And, I said: "Look, if you can demonstrate that there is a very significant benefit to a specific type of outlay, then I think it has a priority." In my judgment, it is very difficult to do that usually in most cases, and in the particular instance where the educational system has been very dramatically enhanced by the need to increase the skills of the working age population. Most of the types of programs which one would like to put into a government form, I think, in part, are already existing. But if you can find one which really comes to grips with something which would enhance the skills of the workforce, I would think it would—one would have to——

Mr. BILBRAY. So in other words, spending that you could prove a nexus between cost-benefit ratio, a direct nexus.

Mr. GREENSPAN. I am sorry, give me that question again.

Mr. BILBRAY. In other words, spending or investment that could show a direct nexus to a benefit, a direct benefit revenue enhancement?

Mr. GREENSPAN. Yes.

Mr. BILBRAY. I guess what it really comes down to, when we talk about this issue of investing into the stock markets—and correct me if I am wrong; I was a history major. It sort of reminded me—I think Mussolini was the man who really came up with the idea of government funds making major investments in the Italian stock market at one time. Somebody may correct me later on that.

My question, though, is: It really comes down to trust. Do we have more trust in the security of a communal investment of our retirement programs or do we have more as an individual, have more trust in the individual, to be able to monitor, at least, the supplemental side of the retirement program? And, I would use an example.

Here in the Federal system, the Federal employees and Members of Congress pay a base Social Security participation, but, as a supplemental, have individual retirement accounts to be able to reduce the dependency on the communal fund. Do you see major problems with the rest of the Nation being able to opt into this supplemental element, and being rewarded for it, as those of us in the Congress and those in the Federal employment have today?

Mr. GREENSPAN. I personally think not, but, you know, what we are talking about here is a really fundamental view of the way our society functions and the willingness that we all have to take risks or not take risks. The choice of what type of risks you want to take in your life differs form individual to individual. I think we ought to give people the ability to differentiate amongst themselves.

Mr. BILBRAY. To allow the individual to make the choice?

Mr. GREENSPAN. Allowing the individual to make that choice. I mean, you can, at this particular stage, if you are, say, 25, you could take all of your Social Security taxes and invest it in, say, safe corporates—or, something like that—corporate debt, with a little bit of equity, have a little bit of risk involved. Or, you could have a huge equity portfolio and take very large risks——

Mr. BILBRAY. So, in other words——

Mr. OXLEY. The gentleman's time has expired. We have got to get to——

Mr. BILBRAY. I appreciate that, and I appreciate the fact that we address this issue that a government monopoly isn't necessary always the best way to provide security to individuals. And, I appreciate your testimony. I yield back, Mr. Chairman.

Mr. OXLEY. The gentleman from New York.

Mr. FOSSELLA. Thank you, Mr. Chairman.

Chairman Greenspan, with respect to tax reduction, talk about targeted tax relief as opposed to, say, a reduction in the marginal tax rates. What do you think is the appropriate course?

Mr. GREENSPAN. Well, as somebody that is looking at the economy, clearly marginal tax rates, by all measure, have significant impact on economic efficiency and growth, whereas, targeted ones do not, or at least certainly not to the extent that cuts in marginal rates would do.

Mr. FOSSELLA. Thank you. Do you feel that there is an opportunity, in your hierarchy, to reduce the debt, or is that just something that is not possible at this point in time?

Mr. GREENSPAN. You mean to reduce the debt? I think that, one, we are reducing it now, and I would hope we would continue to do that. In fact, if we run a surplus, there is almost no alternative but to reduce debt. The only other alternative is for the U.S. Treasury to buildup cash balances, which it can only do up to a certain limit. And, reduction of debt, in my judgment, is clearly something which will probably make long-term interest rates lower than they otherwise would be; mortgage rates would be lower. I think there are some very considerable benefits from lowering the aggregate level of debt in this country.

Mr. FOSSELLA. Okay, I have other questions I will submit.

But, in light of the time, I want to shift gears for a second on a totally different topic and that has to do with the subcommittee, once again, considering the financial services reform. One issue that has raised some concern is using taxpayer dollars to subsidize activities of bank operating subsidiaries.

I want to enter, Mr. Chairman, for the record, pieces of a March 1st issue of Business Week—first, a commentary that notes that Federal safety net deposit insurance and access to the Fed's emergency funds, gives banks a lower cost of capital that should not be used to subsidize banks and securities, insurance, or other fields. That observation is that the safety net might encourage banks to take bigger risks at the expense of taxpayers. And, the second editorial asserts that it makes sense to separate the securities, insurance and banking business, as the Federal Reserve suggested, through separating capitalized affiliates, rather than operating subsidiaries.

[The information referred to follows:]

[Business Week/March 1, 1999]

COMMENTARY

THE STARING CONTEST THAT'S STALLING BANK REFORM

By Mike McNamee

Could it be that, after a quarter-century, the planets have finally aligned for an overhaul of the U.S. financial system? It seems so. Three big chunks of the industry—banks, securities firms, and insurers—agree that the old rules restricting mergers among them should go. Republicans and Democrats alike agree it's time for reform.

But Washington's biggest financial stars remain out of line. Federal Reserve Chairman Alan Greenspan and Treasury Secretary Robert E. Rubin can't agree on how banks should operate securities and insurance arms—and on who will oversee the new combinations.

It's time for these titans to quit squabbling. Greenspan has the right idea: The risky business of underwriting securities and insurance should be kept outside the walls of banks, in separate affiliates. This holding-company setup would put supervision under the Fed, where GOP leaders and the securities industry agree it should go. Even banks aren't fighting that.

But Rubin is. The Treasury chief wants to let banks conduct securities and insurance operations within subsidiaries owned by the bank. "Financial-services firms should have the choice of structuring themselves in the way that makes the most business sense," he says. Another benefit for Rubin: That approach would ensure continuing oversight by Treasury's Office of the Comptroller of the Currency (OCC), which regulates national banks. The Fed regulates holding companies that own banks, so Greenspan's proposal would reduce the OCC's role.

Financial-services reform is too important to be held hostage to bureaucratic egos. "We are more than willing to sit down and find a way to increase [Treasury's] powers," Greenspan told the House Banking Committee on Feb. 11. "And if it comes out of the turf of the Federal Reserve, so be it."

Public Trust.—The real issues, the Fed chief maintains, are fair competition and proper use of the federal safety net—deposit insurance and access to the Fed's emergency funds. That backing gives banks lower cost of capital, which, Greenspan rightly asserts, should not be used to subsidize banks in securities, insurance, or other fields. That safety net might also encourage banks to take bigger risks than their rivals in, say, stock underwriting, because they know taxpayers stand behind their losses.

In the end, Greenspan is likely to prevail. Rubin has already conceded that insurance underwriting belongs outside of banks. If the Fed chief gives Rubin a small concession, they might strike a deal. What could Greenspan offer? Senate Banking Committee Chairman Phil Gramm (R-Tex.) on Feb. 16 proposed one idea: Smaller banks could underwrite securities and insurance through subsidiaries, while other banks would operate through Fed-regulated holding companies.

Over the past four years, Rubin and Greenspan have taken Treasury-Fed cooperation to new heights. They should keep working together now—to make financial reform a reality.

[Business Week/March 1, 1999]

EDITORIALS

TIME FOR SOME NEW THINKING, MR. RUBIN

As U.S. Treasury Secretaries go, Robert E. Rubin has got to be one of the best. His old-fashioned fiscal rectitude helped transform federal budget deficits "as far as the eye could see" into surpluses that reach deep into the next century. Along the way, he helped set the stage for the longest peacetime economic expansion in history. Rubin's deep knowledge of markets, at a time when markets define so much of our lives, makes him a bastion of confidence to the business community. And his personal modesty is matched by a less-is-more approach to policy. Pick an issue, from tax reform to bank reform, from restructuring the IRS to redesigning the international financial architecture, and he invariably chooses a minimalist approach. Rubin's caution often serves him, the United States, and the global economy, well.

But not always. Take international finance. In a little-noticed speech given to the World Economic Forum in Davos, Switzerland, Rubin poured cold water over each and every proposal to curb the volatility of global capital markets. Rubin cast a skeptical eye on capital controls, early warning systems, pre-qualification for IMF borrowing, curbing hedge funds, currency target zones, etc. The analysis was coldly brilliant, but the accretion of "no's" added up to a virtual veto of any attempt to fix the global financial system—and was seen as such by Europeans, Asians, and Americans in the audience.

Yet some changes are needed, especially in emerging markets that are not yet ready for unfettered capital inflows. The nonconvertibility of the renminbi shielded China from the Asian crisis, and there were capital controls in effect in the U.S. and Europe for decades after World War II. Tax penalties on short-term capital inflows, to take one example, have worked for Chile, and they might be good for other small countries. As for hedge funds, why shouldn't they be regulated like all other financial institutions? It may be difficult, but it's not impossible.

Rubin's bias against bold changes also works against needed reform in banking. Banks are moving quickly into securities and insurance. The Federal Reserve wants banks to use holding companies to contain each separate business. Large banks already do so. The Treasury insists that banks should be allowed to operate securities and insurance businesses within the traditional banking structure.

But Rubin's Treasury is wrong. These new businesses are very different from traditional lending. Indeed, banking alone has proved to be risky enough for the government to have set up deposit insurance and a whole raft of safety measures that are not applicable to securities and insurance. It makes sense to separate each business and not mix them. It makes for greater transparency and sounder regulation.

Rubin was scheduled to fly to Bonn, Germany on Feb. 20, for a meeting of the Group of 7 industrial nations. Topic "A" is how to avoid future global financial crises. The Europeans and Japanese prefer heavily managing the markets. This is hardly the optimal solution, but neither is doing nothing. The key to dealing with a fast-changing world economy is knowing when to create new rules and institutions to fit the new reality. That's the challenge before the Treasury Secretary.

Mr. FOSSELLA. Mr. Chairman, could you just discuss the public policy concerns raised by the operating subsidiary structure that has been proposed by some Members of Congress, and how could these concerns be addressed? And I will conclude my questions.

Mr. GREENSPAN. Well, the issue is fundamentally, as you know, Congressman, the question of whether the new powers in financial modernization are put into the affiliates of holding companies or into subsidiaries of commercial banks. It is our judgment—and I think the evidence very strongly supports it, and, indeed, we would agree with the comments of the editorial you just read—is that there is a quite significant subsidy that inures within the bank, owing to, one, deposit insurance, access to the discount window at the Federal Reserve, and having effectively guaranteed payments from the Fed wire system. They are reflected in a lower cost of capital for bank issuances, debt of banks, than even the holding company of that bank, and especially, those who have to compete with those banks, finance companies, securities companies, and the like, who do not have access to the safety net and do not have the subsidy.

My general view, as I have stated on numerous occasions, is that we at the Federal Reserve support all of the powers, that are embodied in the financial modernization bill. But we believe that they should be financed in the marketplace. Which means that affiliates of the holding company would have to finance at higher credit costs, rather than be effectively using the sovereign credit of the United States to help subsidize and finance these new powers. I think it would be a mistake to do that.

Mr. OXLEY. The gentleman's time has expired.

Mr. FOSSELLA. Thank you.

Mr. OXLEY. Mr. Chairman, again, thank you so much for your wonderful testimony. We found it most helpful in our deliberations.

With that, the subcommittee stands at recess until 1:30.

[Brief recess.]

Mr. OXLEY. The subcommittee will come to order.

We are honored today to have the Treasury Deputy Secretary, Lawrence H. Summers, testifying. I know that, Mr. Summers, you have had a busy morning already in another committee. We appreciate his perseverance and patience in coming to the Finance and Hazardous Materials Subcommittee to testify on a very timely issue; that is, the issue of Social Security as it relates to investments in the stock market, which, of course, comes under the jurisdiction of this committee.

So, as I understand, this is your maiden appearance before the Commerce Committee, Mr. Summers. We appreciate your willingness to appear, and we will turn it over to you.

STATEMENT OF LAWRENCE H. SUMMERS, DEPUTY SECRETARY, U.S. DEPARTMENT OF TREASURY

Mr. SUMMERS. Thank you very much, Mr. Chairman, Mr. Ranking Members Towns, members of the committee. I appreciate the opportunity to appear today to discuss President Clinton's proposals to ensure the financial well-being of Social Security. I have a long statement which I will submit for the record.

Mr. OXLEY. That will be made a part of the record, without objection.

Mr. SUMMERS. If I might just briefly summarize just a few comments, Mr. Chairman.

The basis of the President's approach is this: We have a remarkable opportunity in this country with $4.8 trillion in budget surplus projected over the next 15 years. We have a large challenge in this country with an aging population. The President's approach marries the two by contributing the lion's share of the projected surpluses to the Social Security Trust Funds to meet the Social Security challenge.

This proposal has important economic benefits, as Chairman Greenspan stressed in his testimony before you this morning. By preserving the unified surplus, and reducing the national debt, it increases America's national savings rate and increases the supply of capital that can flow into new plant and equipment for American workers and new homes for American families.

It also makes important room in the Federal budget. On the current projections, which are, of course, uncertain, the President's proposals, if enacted, will substantially eliminate the national debt by the middle of the 2010-to-2020 decade. That will result in interest savings of hundreds of billions of dollars, nearly 2.5 percent of GDP, enough to finance the increment to Social Security benefits that will occur as a consequence of the aging population. By contributing the proceeds of deficit reduction to the trust fund, we ensure that those savings will be put to that crucial use.

The President's proposal also contains a proposal for USA accounts that would strengthen the non-Social Security pillars of our national retirement security system by making universal savings accounts, a kind of pension coverage, universally available, and available, in particular, to the 73 million Americans who have neither IRA's nor 401(k)s nor private pension arrangements.

The focus of this hearing, as I understand it, Mr. Chairman, is on a different aspect of the President's proposal, and that is the President's call for use of a portion of the Social Security Trust Funds for equity investments. This in line with best practice in the management of defined-benefit pension plans in both the public and the private sector, where in almost all cases a substantial amount—in many cases in excess of 40 percent—of pension funds are invested in equities, so as to realize the extra returns that equities have proven to run over the longer term. The President's proposal calls for a conservative 15 percent of the Social Security Trust Fund to be allocated to equity investments.

Just as private and public sector managers of defined-benefit pension plans choose equity investments as a way of making those pension plans operate more efficiently, so, too, Social Security equity investments can have important benefits. Even the limited equity investments contemplated by the President's proposal would obviate the need for what would otherwise be a 5 percent across-the-board benefit cut in 2030, or an increase in the retirement age of 18 months for participants who reach age 67 in 2022. Equity investments would have comparable long-term actuarial benefits to those rather radical steps.

Now equity investment raises a number of questions. One is with respect to risk. Of course, the risks of government equity investment will be felt much less by any individual than would be the case in the context of an individual account. So the government would guarantee a defined benefit and would have the capacity to smooth equity returns over very long periods of time.

We have carefully considered the risks, and risks at the level of the equity investment contained in the President's program are, in our judgment, manageable. In the outyears, approximately 70 percent of benefits will come from, will be paid out of, the continuing stream of payroll tax revenues. Even in 2032, the remaining 28 percent will be paid out using assets of the trust fund. Of that 28 percent, only 15 percent would depend at all on equities—making the system very safe.

A second concern that has been raised, and a very serious concern, in our view, is the concern about the integrity of Social Security investments. Here we recognize the seriousness of this issue and envision an approach with a number of protections. First, the investments would be limited. Second, the investment would be managed by an independent Senate-confirmed board. Third, the board would not do the investment itself, but would, instead, only be free to select private sector managers. Four, those private sector managers would be charged not with discretionary investment either with respect to timing or particular securities, but only—only—with respect to investing in broad-gauge indices.

We believe these four protections taken together would provide adequate protection for the assurance of the integrity of the investment process and the permit the 50 percent of Americans who don't own stock, and depend almost entirely on Social Security for their retirement benefits, to realize the same kinds of benefits of equity investments that the upper half of the population has realized for a long time.

Now there has been a great deal of discussion, Mr. Chairman, of the State and local experience in this regard. There are different readings of that experience. I would highlight just two points.

One is that the best available evidence appears to us to suggest that, while some time ago there was a lag in the returns on State and local pension funds relative to stock market indices, it appears that in recent years, over the last decade or so, any differences have been negligible, and that the main reason why that lag has been made up is that State and local government pension funds have increased equity investments, to the point where their equity investment rate is roughly comparable to that of the private sector. Previously, it had lagged, and that had been a large part of the reason why their total return had lagged.

But I think there is a second crucial point, and that is that the practices under which Social Security would be managed differ from those that have been in some cases used in the State and local sector. In particular, many State and local statutes actually prescribe various kinds of social investing, whereas, the statute we contemplate would proscribe that kind of investing. Unlike the case in the State and local sector, we would constitute a legally binding obligation to invest only in whole market indices, and not to engage in discretionary stock picking, which would have the prospect in a Social Security context of various kinds of mischief.

Again, if investments take place in the whole of market indices, there is really no scope to either underperform the market or outperform the market. Capital would be allocated in a way that is very consistent with the way that market forces are now allocating capital.

Let me conclude by addressing a subject that is of obvious relevance, given the ongoing debates. That is the relative merits of the collective approach that is embodied in the President's budget versus the individualized investment approach that has received a great deal of discussion. We believe that there is a role for individualized investment. That is why the President has put forth the universal savings account as a way of strengthening our Nation's pension and private savings system. But in a Social Security context, we believe that the collective investments approach is best for three separate reasons:

First, it minimizes risk to individuals. In 1974, for example, over one 12-month period, the stock market fell by more than 50 percent, and individual accounts at that point for someone retiring would have led to a very unpleasant surprise about retirement benefits. The Social Security System, operated like a defined-benefit pension plan, would have the opportunity to smooth those kinds of fluctuations out over many years without disruptions to individual benefit levels.

Second, a collective investment approach economizes on administrative costs. One of the great things about Social Security as an insurance program is that 99 cents out of every dollar of taxes or contributions that are made are paid out in benefits. Best available evidence, looking at the British experience, looking at the Chilean experience, looking at private experience with mutual funds, suggests that administrative costs of 100 basis points would reduce by 20 percent the total account accumulations at the end of a 40-year period, if one pursued an individual investment approach.

Third, the collective investment approach preserves the basic progressivity and integrity of the Social Security Program, which is much more than a private pension system. It is a system of income support. It is a system for meeting survivors' needs, for meeting the needs of disability. So, in that way as well, it seems to us to be a preference approach.

So, for these three reasons—administrative costs, progressivity, minimization of individual risk—we believe that the collective investment approach with adequate safeguards is the best way forward.

I might just note that, if one is concerned about the integrity of investments—and I think one should be, although those concerns can be managed—that concern is in no way unique to proposals for collective investments, because any system of federally administered individual accounts would run into the same issue of a generalized mandate that the Federal individual accounts couldn't invest in stocks of a certain kind or needed to target a certain portion of their investment to a particular use. So that is a problem we are going to have to address, and address in a way that makes us all feel comfortable, no matter what type of approach that we pursue.

Finally, I might just note that the Markey-Bartlett bill, which has been recently introduced, seems to us to be a positive step forward in the debate, embodying as it is does the notion of an independent board, private sector managers, and indexing for investment choices. This is a very complicated subject, but it is at least as important as it is complicated. Speaking for all my colleagues in the administration, I know we recognize that our prospects of finding a solution can be realized in only one way: by working in a very cooperative way, both on a bipartisan and bicameral basis, involving all of those concerns, to chart the best course. That is what we are determined to try to do, working with you, Mr. Towns, members of this committee, and members of other committees in the Congress.

Thank you very much.

[The prepared statement of Lawrence H. Summers follows:]

PREPARED STATEMENT OF LAWRENCE H. SUMMERS, DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

Mr. Chairman, Mr. Ranking Member, and Members of the Committee, I appreciate the opportunity to appear today to discuss President Clinton's proposal to ensure the financial well-being of the Social Security and Medicare programs and improve the retirement security of all Americans.

The advent of an era of surpluses rather than deficits has radically transformed our national debate about entitlements. The terms of all of the earlier tradeoffs in the entitlements debate have been eased—provided we seize the opportunities now available to us. The President's framework for Social Security both recognizes the brighter present reality, and moves us well along the road toward seizing the opportunities currently available, if we can work together on a bipartisan basis.

Today I will first briefly describe the President's program. I will then devote the bulk of my remarks to the issue of the President's proposal to raise the rate of return earned by the Social Security trust funds by investing part of the surplus in equities.

The President's Proposal

According to the Office of Management and Budget, the surpluses in the unified budget of the federal government will total more than $4.8 trillion over the next 15 years. This presents us with a tremendous opportunity. At the same time, we are also facing a tremendous challenge: the aging of the "babyboomers" is projected to put enormous strains on the Social Security and Medicare systems, on which so many retirees depend.

The natural approach would be to take advantage of this opportunity to meet the challenges facing us. This is the objective of the President's plan.

The President's framework devotes 62 percent of these projected budget surpluses to the Social Security system. Of the roughly $2.8 trillion in surpluses that will go to Social Security, about four-fifths will be used to purchase Treasury securities, the same securities that the Social Security system has invested in since its inception. The remaining one-fifth will be invested in an index of private-sector equities. These two actions will reduce the 75-year actuarial gap from its current level of 2.19 percent of payroll by about two-thirds, to 0.75 percent of payroll. And they push back the date at which the Social Security trust funds are projected to be exhausted, from 2032 to 2055.

Substantial as that accomplishment would be, it is critical that we do more. Historically, the traditional standard for long-term solvency of the Social Security system has been the 75-year actuarial balance. A 75-year horizon makes sense because it is long enough to ensure that virtually everyone currently participating in the system can expect to receive full payment of current-law benefits. Attaining this objective will require additional tough choices. But the objective is both important and obtainable. To reach it, the President has called for a bipartisan process. We believe that the best way to achieve this type of common objective is to work together, eliminating the need for either side to "go first."

In the context of that process, we should also find room to eliminate the earnings test, which is widely misunderstood, difficult to administer, and perceived by many older citizens as providing a significant disincentive to work. In addition, it is critical that we not lose sight of the important role that Social Security plays as an insurance program for widows and children, and for the disabled. As President Clinton said last month: "We also have to plan for a future in which we recognize our shared responsibility to care for one another and to give each other the chance to do well, or as well as possible when accidents occur, when diseases develop, and when the unforeseen occurs." That is why the President has proposed that the eventual bipartisan agreement for saving Social Security should also take steps to reduce poverty among elderly women, particularly widows, who are more than one and one-half times as likely as all other retirement age beneficiaries to fall below the poverty line.

In addition to shoring up Social Security, the President's plan would transfer an additional 15 percent of the surpluses to Medicare, extending the life of that trust funds to 2020. A bipartisan process will also be required to consider structural reforms in this program. The Medicare Commission is expected to report soon on these important issues.

The President would also use 12 percent of the surpluses to create retirement savings accounts—Universal Savings Accounts or USA accounts—and the remaining 11 percent for defense, education, and other critical investments. The President will be announcing further details regarding the USAs soon.

At the same time, the President proposes to strengthen employer-sponsored retirement plans in a variety of ways. The President's budget addresses the low rate of pension coverage among the 40 million Americans who work for employers with fewer than 100 employees by proposing a tax credit for start-up administrative and educational costs of establishing a retirement plan and proposing a new simplified defined benefit-type plan for small businesses. Workers who change jobs would benefit from the budget proposals to improve vesting and to facilitate portability of pensions. In addition, the retirement security of surviving spouses would be enhanced by the President's proposal to give pension participants the right to elect a form of annuity that provides a larger continuing benefit to a surviving spouse and to improve the disclosure of spousal rights under the pension law.

Benefits of the President's Approach

In essence, the President is proposing that we use the Social Security and Medicare trust funds to lock away about three-quarters of the surpluses for debt reduction and equity purchase, and ensure that they are not used for other purposes. This would have three key effects:

- First, it would greatly strengthen the financial position of the government. If we follow this plan, by 2014, we will have the lowest debt-to-GDP ratio since 1917 and will free up a tremendous amount of fiscal capacity. The reduction in publicly held debt will reduce net interest outlays from about 13 cents per dollar of outlays in FY99 to about 2 cents per dollar of outlays in 2014. Under the President's program, the decline in interest expense resulting from debt reduction will exceed the increase in Social Security expense through the middle of the next century.
- Second, it would strengthen significantly the financial condition of the Social Security and Medicare trust funds. Indeed, it would extend the life of the Social Security trust funds by more than 20 years, to 2055, and extend the life of the Medicare Hospital Insurance trust funds to 2020. Meeting our obligation to the next generation of seniors should be the number one priority in allocating the surpluses.
- And third, it would substantially increase national saving, which must be a priority in advance of the coming demographic shift. By paying down debt held by the public and investing in equities, the President's program will create room for about $3.5 trillion more investment in productive capital. In effect, this will be the reverse of the "crowding out" that occurred during the era of big deficits. With government taking a smaller share of total credit in the economy, interest rates will be lower than otherwise would be the case. The implications of lower interest rates will be profound. Not only will individuals be able to borrow for mortgages, school loans, and other purposes at lower rates, but importantly, businesses will be able to finance investments in productive plant and equipment at the lower rates. And the resulting larger private capital stock is the key to increasing productivity, incomes, and standards of living. Ultimately, one reason why this program is sound economically is that it will result in a more robust private economy, which will expand our capacity to make good on our Social Security and Medicare promises. This increase in public saving also has

beneficial implications for our balance of payments side. Reduced government borrowing would lead to a reduced dependence on foreign financing, and an improvement in our status as a net debtor to the rest of the world.

Benefits of USA Accounts

Social Security, strengthening employer-sponsored retirement plans, and creating USA accounts are key pillars of the President's proposal to provide financial security to retirees. We believe that USA accounts will provide a significant stimulus to private savings, by enabling millions of Americans to begin to set aside some money for retirement.

The President's proposal aims to deal more broadly with the challenges of an aging society by expanding individual access to retirement saving. As I noted earlier, the President proposes to devote 12 percent of the surpluses to establishing a new system of Universal Savings Accounts. These accounts would provide a tax credit to millions of American workers to help them save for their retirement. Workers would qualify for a progressive tax credit match against their own contributions. For example, a low-income worker may receive a dollar for dollar match up to a cap. In addition, low- and moderate-income workers will qualify for an additional tax credit, even if they make no contribution themselves.

Overall, the USA program would be considerably more progressive than the current tax subsidies for retirement savings—where higher bracket taxpayers get higher subsidies. This proposal would contribute significantly to national savings, because it will produce retirement savings for millions of low- and moderate-income people who do not have access to pensions. The tax credit match will provide a strong incentive for workers to add their own saving to accounts.

Investing Part of the Surplus in Equities Would Raise the Rate of Return Earned by the Social Security Trust Funds

As I have mentioned, the President has proposed transferring 62 percent of projected surpluses to Social Security, and investing a portion of these transferred surpluses in equities.

To date, the trust funds have been invested exclusively in U.S. Government bonds. While these bonds are essentially risk-free, they have the corresponding downside that they have historically paid a lower rate of return, on average, than other potential investments. Between 1959 and 1996, the average annual rate of return earned on stocks was 3.84% higher than the rate earned on bonds held by the trust funds.

Currently, the pension savings of many upper income Americans are invested in private plans that earn these higher equity returns. The higher equity returns can potentially make it possible for these Americans to have more upon retirement. We believe that it is important to give all Americans, even those of low and modest means, the opportunity to enjoy these potential benefits from stock market performance.

Raising the rate of return on the trust funds would mean that the Social Security system could be brought into long-term actuarial balance with smaller reductions in benefits, smaller increases in revenue, and/or less transfer of surplus. The President's plan for investing in equities will reduce the actuarial gap by an estimated 0.46 percent of taxable payroll—and thus will close roughly one-fifth of the problem we face over the next 75 years. If one were to try to achieve the same actuarial impact of equity investments through alternative measures, we would have to immediately reduce the COLA on Social Security benefits by 0.3 percentage points. The equity investment in the President's package achieves as much for the financial soundness of the system as would moving the normal retirement age up by about an extra year and one-half for participants who reach age 67 in 2022. If we delayed until 2030 to make the changes necessary to set Social Security back on a sound actuarial footing, the required across-the-board cut in benefits would be 5%.

Investing part of the trust funds in equities would also bring Social Security into line with the "best practice" of both private and public sector pension plans. Among large private-sector defined benefit plans (those with more than 100 participants), more than 40% of total assets were invested in equities in 1993; this number has risen significantly since then. Nearly all state pension plans also now invest in equities. In 1997, state and local government plans invested 64% of their portfolios in equities.

I want to take a moment to applaud the efforts and leadership of Congressman Markey, Congressman Bartlett and Congressman Pomeroy, who have introduced a bill authorizing the investment of a portion of the trust funds in equities. We welcome their commitment to ensuring that trust fund investments are insulated from political pressures.

Would Equity Investments Add Risk to the Trust Funds?

I see two broad concerns regarding trust fund investment in equities. These concerns are legitimate, but we believe they are manageable, and should not stop us from achieving the potential enhanced returns of equities.

First, stock returns are more volatile than the returns on the government bonds held by the trust funds. However, the trust funds are well-situated to bear equity risk, because they have long—or indefinite—time horizons. The trust funds would be capable of riding out the ups and downs of the market, because they receive the cash flow from payroll taxes, and because of the cushion provided by the trust funds' bond holdings.

More specifically, investing only 15 percent in equities seems to us to be a prudent balance between receiving the potentially greater return from equities and keeping the investment small enough so that the trust funds are not overly exposed. This 15 percent allocation to equities is much smaller than the customary allocation to equities in either public or private pension plans. Moreover, 85% of the trust funds will still be invested as before in risk-free Treasury securities.

In addition, the equity investments and disinvestments that we are proposing will be smoothed in incremental additions over 15 years. In any year, investments or disinvestments are projected to be less than 0.5% of the stock market. Incremental investments and disinvestments—rather than total divestiture at one time—will help to mitigate the risk from adverse price movements.

Finally, in the near term, all benefits will continue to be paid out of payroll and other taxes. Furthermore, under current law, even in 2032 payroll and other taxes will be sufficient to pay for the lion's share—about 72%—of Social Security benefits. The remaining 28% of benefits will be paid out using the assets of the trust funds. As only 15% of the trust funds' assets would be invested in equities, only about one sixth of this 28% would be backed by equities. In short, even in 2032, only about 4-5% of payments from the trust funds will be backed by private sector investments.

Ensuring the Integrity of Investment Decisions

The second concern is that of political influence on trust fund investment decisions. Any system of collective investment can and must address these concerns. We believe that we can successfully work with Congress to design a system that is free from political influence. We need to strike the right balance, so that we can earn the higher potential returns to equities, by finding a way to take care of these legitimate concerns.

That is why we will work with Congress to design a system that observes *five core principles*. These five core principles will establish several levels of protection.

First, the share of trust fund assets invested in equities ought to be kept at a very *limited* level. We have proposed that equity investment be limited to 15 percent of trust fund balances. This will be important to limit the trust funds' exposure to price movements from equity investments, and to ensure that collective investments never account for more than a small fraction of the stock market. During the first years of the program, from 2001 to 2014, Social Security would own, on average, only 2% of the stock market. On average through 2030, Social Security would own approximately a 4% share of the total stock market.

Second, the investments should be *independently managed and non-political*. We suggest that trust fund managers be drawn from the private sector through competitive bidding and that the trust fund managers be overseen by an independent board. There should be wholly independent oversight of investment, in order to shield the trust funds from political influence.

Third, the sole responsibility of the independent board would be to *select private sector managers through competitive bidding*. Private sector management will provide a further degree of political insulation. Moreover, Social Security beneficiaries deserve the same efficient management and market returns that people receive for their private pensions and personal savings.

Fourth, equity investments should be *broad-based, neutral and non-discretionary*. Assets should be invested proportionately in the broadest array of publicly listed equities, with no room for discretion in adding or deleting companies and no room for active involvement in corporate decisions. We have proposed that the funds be invested in a total market index, which would encompass a broad range of stocks. In addition, the managers should be on autopilot in investing the funds; they should have little or no discretion in the investment of trust fund assets, so they cannot "time the market" or pick individual stocks.

As a shareholder the trust funds should be entirely passive. One way to accomplish this might be to mandate that proxies be voted in the same proportions as other shareholders.

Fifth and finally, collective investment needs to be achieved at the *lowest cost* available. This will be important both to obtain the highest possible returns and to further enhance the system's transparency and independence. Indexed investment is less expensive than active management. In addition, given the large size of the potential equity investments by Social Security, we would expect to pay very low asset management fees.

Let me emphasize our belief that there should be zero government involvement in the investment. We will work with Congress to design a system that is completely insulated from political pressures.

The Experience of State and Local Governments

As I mentioned earlier, virtually all state pension funds now invest in equities. In 1997, state and local government plans invested 64% of their portfolios in equities, up from 56% in 1996. State and local pension plans now hold fully 10 percent of the overall stock market. By contrast, the Social Security trust fund equity investments would total only 15% of the trust funds, and would represent, on average, about a 4% of the equity market.

Some have suggested that the trust funds might fall short of earning market returns, based on the experience of state and local pension plans. I would emphasize first that the experience of state plans is really not directly comparable to what we are proposing for Social Security. State plans do not generally operate under the kinds of restrictions that are envisioned under the President's proposal. That is, the statutes governing state plans do not generally require that investments be made only through indexed funds, with a clear prohibition against adding or subtracting equities from the index. Many state pension plans are actively managed, and some have explicit investment goals. As a result, the experience of these plans may not be relevant as a guide for what Social Security's experience would be.

Our preliminary analysis of the available data suggests that, over the period 1990-1995, public plans actually received returns that averaged two basis points higher than private plan returns (this difference is statistically indistinguishable from zero). Although in earlier periods (from 1968 to 1983) the performance of public pension funds was slightly inferior to that of private pension funds, this difference is also not statistically significant. More importantly, this very slight difference in performance during earlier periods can be explained by the fact that public pension funds generally allocated a far smaller portion of their portfolios to equities, and in some cases were statutorily prohibited from buying any equities.

The returns to trust fund investments to this date would not stack up well in this comparison of earnings of public and private pension funds. Because the trust funds have been invested exclusively in government securities until now, both public and private pension funds would likely have outperformed the rate of return earned on trust fund investments.

Advantages of Collective Investment of Social Security

There are three key advantages to having the trust funds invest collectively in equities for the American people. These advantages relate to the ability of defined benefit plans to bear market risk, minimize administrative costs, and achieve progressivity. Defined contribution plans, such as the proposals for individual accounts, are less able to realize these objectives. In addition, the potential political risk from collective investment in equities through the trust funds is not very different from the political risk that could arise from investing in equities through defined contribution plans.

An advantage of collective investment in equities through the trust funds is that periods of poor equity performance could be spread over many generations of current and future Social Security participants. By contrast, during a market downturn, participants in a defined contribution system could be forced to choose between postponing retirement and a severely reduced retirement income. For example, for the year that ended with the third quarter of 1974, the S&P500 declined by 54 percent in real terms. By placing the risk of a market downturn in the trust funds, we can greatly reduce this risk to beneficiaries. Additionally, we have proposed limiting Social Security's equity holdings to 15% of the trust funds. As I noted earlier, this means that only 4% of benefits payments would be backed by the performance of equities.

The second advantage of collective investment in equities is that the returns to trust fund investments in equities would likely be higher than the returns to equities held in individual accounts. This is primarily because it would be much more costly to administer a defined contribution plan than it would be to administer a defined benefit plan. The trust funds would expect to pay very low asset management fees, because of the large size of the trust fund asset pool. These asset management fees could be comparable to, or lower, than the 1 basis point (0.01%) currently paid by the federal employees' TSP plan for private management of the equity-indexed "C Fund."

By contrast, administrative costs for a system of defined contribution plans held in the private sector could be comparable to the commissions and fees charged by equity mutual funds today. The average equity mutual fund currently charges between 100 and 150 basis points for administrative and investment management services. Costs of this magnitude could significantly reduce the balance that could be accumulated in an individual account. According to our estimates, administrative costs of 100 basis points would reduce by 20 percent the total account accumulations at the end of a 40-year career. Collective investment through the trust funds would avoid the need to pay the administrative costs associated with individual accounts.

The experience of individual accounts in Britain and Chile illustrates how significant these risks and costs can be. In Britain, many personal pension plans take more than 5 percent of contributions in administrative charges.

Chile also has had high administrative costs. According to the Congressional Budget Office (CBO), fees and commissions of the Chilean pension system amounted to 23.6 percent of contributions in 1995. As a result, according to the CBO, Chilean workers who invested their money in an individual account in 1981 received an internal real rate of return of 7.4 percent on that investment through 1995, despite average real returns of 12.7 percent to pension fund investments. Even in the best of circumstances, however, costs will be higher for a system of individual accounts than for collectively investing trust fund assets.

The third advantage of collective investment is that it is progressive. This is one of the most important features of Social Security: benefits are greater, as a percentage of wages, for low-income workers than high-income workers. By investing in equities, we are able to maintain this critical feature of progressivity and avail Americans of modest means of the higher returns that have historically accrued to equities.

In addition to these key advantages, one might note that, with regard to the concern about political influence, this concern also exists for individual accounts. Most individual account proposals have suggested some centralized plan structure, both in order to reduce administrative costs and to help familiarize tens of millions of Americans with the range of possible investment vehicles. These individual account plans would create a large pool of money under a single manager, or a handful of managers. This pool of money would not look very different from the Social Security trust funds. With any centralized pool of assets there is the potential for those pursuing a political agenda to try to influence it.

We can all be encouraged by the history of the Thrift Savings Plan (TSP), whose investments have not been subject to political influence. We believe that some of the features that have protected the TSP system so well are worth emulating. These include the TSP system's independent board, its private sector managers, and the rule that equity investments can only be made by tracking an index.

Conclusion

In conclusion, it will be critical to have the Administration and Congress work together to address the needs of future generations. We need to keep the promises that we have made to retirees, without unduly burdening younger generations. We want to work with you, on a bipartisan basis, to implement the President's program.

I believe that we can find a safe and prudent way to participate in the enhanced returns in equity markets.

Thank you. I would welcome any questions.

Mr. OXLEY. Thank you, Mr. Summers.

It appears that inherent in the administration's proposal on Social Security was the realization that any increase in the FICA tax or reduction in benefits essentially is not only unpalatable, but probably unpassable in the Congress, which leaves us with the third option, which would be maximizing return on investment. Is that a fair statement?

Mr. SUMMERS. I find economic prognostication difficult enough without attempting political prognostication, Mr. Chairman. But, certainly, I think it is appropriate for us all, before looking at those painful steps, to go the distance that we can go with the approaches of better investment management and making use of the budget surpluses that have been very hard won.

Mr. OXLEY. The original intent of Social Security, if I recall my study in high school and college, was essentially to be a supplement to one's retirement. Has the Social Security System over the years come to be much more than a supplement to one's retirement? If so, should we continue that concept or should we take a look outside the box, if you will, to try to restructure the future of people's retirement and give them more ability to participate in that important endeavor?

Mr. SUMMERS. It is the trite metaphor that I think has been used for awhile in talking about our national retirement. Security system is a three-legged stool. Social Security is one leg, private pension is the second leg, and private savings is the third leg. And, frankly the strength of those legs differs very much across individuals. On an aggregate basis for the age and population, all three of those legs play an extremely important role for millions of people. I don't remember the precise fraction—I'll send it to you in writing—though the social security accounts for the lion share of the resources that they have available in retirement.

I draw from that, Mr. Chairman, two conclusions. One is that we have to work to strengthen the other leg. That is why the administration put forward the USA's proposal along with a variety of other proposals to strengthen the private pension and 401(k) system. That is the first conclusion.

The second conclusion is that, because for the foreseeable future something like half the elderly population would be in poverty without social security, we have to make sure that we recognize that we are working on a highway over which a lot of traffic is flowing, and make sure that any reforms we make in social security preserve the basic protections that it provides, because there are a large number of people for whom that is what will be there during the retirement period.

Mr. OXLEY. You cited the 1 year when the market went down substantially to some 50 percent. And yet we have had testimony before this committee from experts who say that over the long term—which is really what we are talking about in terms of retirement in 25, 30 years in a system—investment and equity actually has provided the most return, about 7 percent, even including back to 1929 through the present. If that is the case, then, indeed, we should not be concerned about the ups and downs of the market. Why would we not give people, empower people essentially, to set up these kinds of accounts to not only take the pressure off of the Social Security System, but, even more so, create more capitalists in our country and allow them to see the magic of compound interest and those kinds of return.

Mr. SUMMERS. Here is the issue, Mr. Chairman: I share your judgment and that of the experts who have testified before you. This is actually a subject I used to work on when I was a professor in the economics area. Over the long run the stock market returns tend to be the best available asset. That we want to give an opportunity to realize the benefits of stock market investments, I share that judgment completely.

The question before us is which of two ways to do that. One approach is the defined-benefit approach, where there is a commitment to provide a defined stream of benefits that is calculated on the basis of average stock market returns, which is funded by the government, recognizing that there will be periods, there will be bear market periods and bull market periods, and as a consequence the size of the trust fund will sometimes rise and the size of the trust fund will sometimes fall, and on average it will work out to provide people with those returns, but you guarantee them a fixed return and they do not experience the risks associated with the stock market. They get their assured benefits. That is the approach that I believe is the sounder approach to social security.

The alternative approach is to say to an individual—in part I suppose it is a political judgment, but it is beyond a political judgment—for an individual, for example, who retired in a year—I cite as an example in 1974—and who had been contributing over their working life since 1935, when what looked like a $1,000 a month benefit when they were 64 turned into a $450-a-month benefit when they turned 65, because that was the year they retired, you could explain to them that it was really okay because over the 40 years since 1935 they had actually done much better than they would have if they had been investing in bonds. But I have feeling that you are going to have some very unhappy people who would have preferred to have been insulated from the risk of that kind of dramatic market movement in the period just before their retirement.

That is why many pension funds in the private sector are on a defined-benefit basis, and I think there is an enormous advantage to that. I think you also have a large number of individuals who are likely to be relatively unsophisticated about markets and who may well be better off. And this is the approach that many employers follow in providing defined-benefit pension plans who are better off realizing the benefits of investments and markets, but not in the way where they are in the position of making their own choices.

Now I am very much aware of people's sense of the difficulty of government doing things effectively, and we would not support an approach in which public investment would take place with substantial discretion. But we believe an auto-pilot approach can be crafted in which the Social Security Trust Fund benefits from the tendency of equities to outperform bonds without getting involved in making discretionary choices. And we think that is what takes advantage of the long-term benefits but does not place, what seems to us, to be unnecessary risks on individuals in their Social Security part of the system.

Mr. OXLEY. The Chairman of the Fed would respectively disagree with that position. I think he testified this morning that he had some grave concerns about that context. I am sure we are well aware of his position and I thought he articulated those quite well.

One of the things I asked Chairman Greenspan this morning was about the Thrift Savings Plan as part of the Federal Employees Retirement System. That is, essentially they now have, or employees have, a choice of three investments from high-risk securities: Put it in a bond index fund, both based on index funds, and then the government's obligation, which are the safest return, but obviously the lowest return, at least historically since 1984. And when I discuss that with my constituents, many of them, particularly the baby-boomers and the younger generations, say, "Well, we ought to have an opportunity to do that. We do not think that there is going to be Social Security there for us, and even if it is, projections are that the returns are going to be less than 2 percent. We think that we could do better if we just went into the safest investment." What would you tell those folks that think that the Feds have a pretty good system?

Mr. SUMMERS. I would tell them three things. I would tell them: First, the Federal workers are also included in Social Security and that the Thrift Savings Plan is a separate and additional system.

Mr. OXLEY. Another leg of the stool.

Mr. SUMMERS. Another leg of the stool for Federal workers, just like pensions are an additional leg for private workers. That is a leg that we need to build on and that is why they should support the administration's USA proposal—is the first thing I would say to them.

The second thing I think I would suggest to them, Mr. Chairman, is that while as tempting as it was, that to focus on the 2 percent return for Social Security was really quite, with respect, a misleading statistic. And the reason is just this: Ninety percent of the Social Security taxes that you and I pay this year are going to go for the retirement benefits of our parents, of my parents' generation. They are not there for us. They are going to meet the obligation that the country entered into 25 years ago. We have got to meet that obligation anyway. So we have no option of sort of making Social Security go away and letting everybody into some Federal Thrift Savings Plan.

The reason why Social Security shows up as having a low return is that we have a large obligation to the current age generation which has not been funded in the past. That is the reason why Social Security shows up as having a low return, and no new system can make that obligation go away. The only choices we can make are, given that we are going to make that obligation, how are we going to provide for retirement benefits in the future? And every bit of return advantage that is potentially available by having people invest in individual accounts is also available through collective investments on behalf of all the people through the Social Security Trust Fund—with the only differences being, on the one hand, the administrative costs, the risk-sharing benefits that I have emphasized, versus, on the other hand, the set of considerations around facilitation and benefits of individual choice that people who favor a more individualistic approach favor.

But the argument about the low return from Social Security is, with respect, I think, not a fair argument because it does not take account of the obligation to pay for my parents' generation's Social Security benefits.

Mr. OXLEY. Well, in fact, our parents' generation did pretty well in their Social Security, did they not? I mean, for them Social Security was a pretty good deal.

Mr. SUMMERS. It has been a very good deal; it has, indeed, been a very good deal. And it is in the nature of the pay-as-you-go Social

Security System that, for those who are there at the beginning, the return is going to be best. While Social Security does, I think, rest on a quite firm foundation, there is a sense in which it is a little bit like a chain. The deal is that I am going to give you a dollar and then you are going to give the person next to you a dollar and that chain is going to continue. The first person who gets a dollar is obviously getting a very substantial advantage. And that is the situation, in some sense, that our parents are in.

Mr. OXLEY. Well, as a matter of fact, some of the severest critics of Social Security would say that is essentially what it is, a fancy scheme that is based on some faulty assumptions, and that, particularly for those baby-boomers and beyond, they walk into that at their peril. Some indications are that some people will never get back the money they paid into the system. Obviously, that is why we are trying to address this shortfall.

Mr. SUMMERS. But I think that points up the fact, Mr. Chairman, on which I think there is now universal agreement. That we need to make, whereas in the past, social security has been a chain, the people who were 40 in 1939 paid for the people who were 70, and then the people who were 40 when they were 70 paid for them, and then that process continued. I think there is now agreement, very widely that we now need to have some system for the baby boom generation of prefunding which the baby boom sets aside increased savings in order to pay for its own social security benefits, rather than putting that burden onto its children. I think what the debate is really about is between two different approaches for putting resources aside.

One, which is the kind of approach that is embodied in the administration's proposal, involves using the budget surpluses, enlarging the Social Security Trust Fund, investing it better and more wisely to meet the obligations. The other involves simply moving to a more privatized approach in which individuals take their own responsibility for their future Social Security. Those are two different approaches to making the very important change that I think we all agree on as a country, which is to work toward prefunding this obligation.

Mr. OXLEY. Let me ask one more question. I have far exceeded my time.

If I understand the USA account, essentially, the government would be providing seed money to people to set up that account. Is that correct?

Mr. SUMMERS. Yes.

Mr. OXLEY. Instead of allowing them to take part of the money they pay now into FICA and fence that and allow them to invest that? So the difference between the USA accounts and ones that are proposed by Chairman Kasich and others, including myself, is the difference between getting people some money out of the surplus to start the account, from your perspective, and from ours it would be to take part of the FICA tax and allow them to invest that portion of the FICA tax they would not pay directly into FICA to set up their own account.

Mr. SUMMERS. I think that is the essential difference. Our approach essentially builds on the Thrift Savings Plan idea by setting up a separate system outside of and reinforcing the Social Security

System on the principle of balancing those three pillars that we talked about.

Mr. OXLEY. Would that also include, then, government matching, like the thrift accounts?

Mr. SUMMERS. Yes. The administration has laid out the general nature of the USA account proposal. We expect to come forward with more details before long, but what I can say at this point is that there would be seed money for people up to a certain income threshold. For them and for people above that income threshold, there would be matching tax credits. For example, for each dollar you contribute into an USA account, you get a tax credit of 40 cents, or whatever it was. So that would also be, in a sense, like the Federal Thrift Savings Plan. It would in some ways be like these tax credits. It in some ways be similar to the deductions that people get on IRAs. But they would be somewhat more generous and I think much more effective and targeted, because of the seed money, in reaching what are more than 70 million people who do not benefit from any of our tax-favored savings vehicles right now.

Mr. OXLEY. Thank you. The gentleman from New York.

Mr. TOWNS. Thank you very much, Mr. Chairman.

Mr. Summers, this morning Chairman Greenspan testified as follows: He said, "I doubt that it is possible to secure and sustain institutional arrangements that will insulate, over the long run, the trust fund from political pressure. These pressures, whether direct or indirect, could result in suboptimal performance in our capital market, diminish economic efficiency, and lower overall standards of living than would be achieved otherwise." Does the administration agree with that statement?

Mr. SUMMERS. No, it does not, although we have enormous respect for Chairman Greenspan, and I think the issues that Secretary Rubin and I have worked with him very, very closely over the last few years, as we have all have. I think the issue he raises is one that has to be considered very carefully. I would just make two points in response.

The first is that the combination of limiting the size of the independent board, private sector management, and investment only in across-the-board indices without discretion—those seem to us to constitute a set of institutional arrangements that would provide the kind of integrity that we are seeking and it would not be subject to the kind of attack that he describes.

The second point that I would make is that, if one looks at the performance of the Social Security Trust Fund, and the return that it earns on government bonds, and compares that with the return that has been earned on pension funds in either the public or the private sector—and, obviously in the public or private sector, some have been invested better and some have been invested worse over recent years. But almost none, even those where the equities investments have turned out not to have been so strategically selected, have, nonetheless, outperformed government bonds and could be expected to outperform government bonds over the longer term.

So I believe that a properly indexed set of investments would actually earn the same average market return that all the other investors earned in the economy with no significant impact on capital allocation in the economy. But even in the event that that somehow proves to be incorrect, and even in the event there ended up being some changes in the allocation of capital, along the lines that we perhaps have seen it in some points in the past in the State and local sector, the performance of the fund would still be substantially stronger than the performance of the trust under current practices of investing it wholly in bonds.

I might also say that, while we are obviously dealing with what is a very important and large issue, we also have an enormously large and liquid capital market in the United States. So I would expect any tendency of this fund to go into one class of investments to be offset by some reallocation on the part of private sector. So I would not expect this proposal to have an important impact on the allocation of capital or its efficiency in the economy. What I think is significant is that it is just good funds management on behalf of what is the most important defined-benefit pension plan in the country.

Mr. TOWNS. I do not know whether you had an opportunity to look at the Markey bill or not, but would that be able to avoid the kind of political pressure that some people are saying that might happen? Would that actually prevent it?

Mr. SUMMERS. I have not had a chance to study in great detail the bill developed by Congressman Markey and Congressman Bartlett. But my understanding is that it embodies what we have identified as the key protections; namely, a public sector board, private sector managers, and wholesale indexing, and, in that sense, I think represents a very constructive step forward.

There is a lot to discuss in this area about how best to do it, and just to reemphasis a point that I made earlier, even if one were to decide to go in a different route toward a more individualized investing approach, one would need to face exactly the same kinds of questions. Because exactly the same kinds of questions would arise when one shows the two or three funds and what rules govern the two or three funds that individuals should choose. So this question that we are talking about is not a question that should be a basis for distinguishing. It is a question we all have to work through and we should work through it together. But it is not a question that is an important question or a high order in distinguishing between a more collective and a more individual approach.

Mr. TOWNS. Thank you. Chairman Greenspan also expressed the view that investing in the Social Security Trust Fund and equity does little or nothing to improve the overall ability of the United States economy to meet the retirement needs of the next century. Could you be more specific about the benefits of the President's plan, given Chairman Greenspan's concern?

Mr. SUMMERS. Sure. As I think, Congressman Towns, I think Chairman Greenspan also recognized in his testimony, the components of the President's proposal that involve preserving the surplus and contributing it to the trust fund offers a politically sustainable way of running the national debt down very substantially and, therefore, increasing national savings. And that, as I think he recognized, represents a very important opportunity to increase national savings, strengthen the economy, so that we can better meet these retirement needs.

The argument for equity investments is not an argument that is grounded in increasing national savings; that comes from another important part of the plan. The argument for equity investments is the argument for good and strong financial management. If you were operating a pension fund for a group of employees and had to choose between asking the employees to contribute more, cutting the employees benefits, and investing the employees' money better, I think you would choose as the best course for the employees to invest their money better. And that is the basic logic of the argument we are making. It is an important one and I think Chairman Greenspan recognizes in his testimony, while he does have some reservations about the overall approach, the likelihood that trust fund investment equities would outperform trust investments and bonds.

The calculations that we have done suggest that this is not small. To get a similar contribution to actuarial balance to that achieved by the President's proposals, investments in equities, you need to have either a 5 percent across-the-board benefit cut in 2030 or, alternatively, an increase in the retirement age of approximately 18 months for people who reach 67 in 2022. It seems to us that in pure Social Security terms, not so much in national economic performance terms, but in pure Social Security terms, the equity investments is the better way to go.

Mr. TOWNS. Final question, Mr. Chairman: He also testified that increasing our national saving rate is essential to any Social Security reform. How does the President propose to increase the national savings rate?

Mr. SUMMERS. I am glad that you asked that. The President's proposal increases the national savings rate by preserving that surplus and increasing the public savings rate by preventing the dissipation of the surplus on new spending or other programs. The President's proposal would essentially save the country money, just as there are two ways I can save. One way I can save is I can put money in a bank account and another way I can save is I can pay back the debt that I owe. In just the same way, the Country can save by paying off its national debt. What the President's proposal would do is eliminate $3.5 trillion of debt on the American people, $3.5 trillion of debt that they would otherwise have to pay taxes or interest on, that they would otherwise have to pay taxes to repay the principal on.

The President's proposal, by using the surplus, would make that debt no longer a burden on the American people over the next 15 to 20 years. That, in turn, would make possible those $3.5 trillion, which now are American savings that is going into the sterile asset of government paper, would instead be available to invest in new plants and equipment, and would instead be available to invest in new homes; and would have one other benefit, which is that in order to maintain the strong level of investment we have in our economy, we are borrowing very substantially from abroad and that is why we have such a large current account deficit and we have all of these trade dislocations. By eliminating the national debt, we would increase American savings; reduce our dependence on foreign capital, and realize the benefit in terms of our trade situation by as well.

So Chairman Greenspan is right about the importance of increasing national savings. The President's proposal on the government side by eliminating the national debt and on a personal side through USA accounts, we believe there is a great deal to increase national savings.

Mr. TOWNS. All right, thank you very much.

Mr. OXLEY. The gentleman from Wisconsin, Mr. Barrett.

Mr. BARRETT. Thank you, Mr. Chairman.

Mr. Summers, I am going to ask you to comment on a couple of the points that Mr. Greenspan made this morning. One of the first points, one of the points he made in his testimony, and I am quoting from his testimony here, "Any increase in returns realized by Social Security must be offset by a reduction in returns earned on private portfolio, which represent to a large extent funds held for retirement. Investing Social Security assets and equities is then largely a zero-sum game." Do you agree with that or what is your response to that statement?

Mr. SUMMERS. In a sense, I agree and, in a sense, Congressman, I would not agree with Chairman Greenspan. It is always true—and this is I think the sense in which he means that—that suppose I make a wiser set of investments; I improve the way that I am investing my money. I am buying a set of things that have higher returns, and somebody is selling those things to me and somebody is buying the lower-return things that I was holding before. So in a sense you could say that that was a zero-sum game. I am better off and they are earning a lower average return.

So whenever somebody improves their own investment performance, there is a sense in which a part of that is going to come at others' expense. My own feeling is that if you have to ask, if you want to frame the question in that way, if you have to ask whether Social Security should subsidize the rest of the economy by running a much lower rate of return than is run by all the other private pension plans, or whether Social Security should improve its own return to bring it more in line with the way other pools of funds are managed in this economy, I would argue that it is a very good thing for the half of population that does not really have important investments elsewhere, and relies on Social Security, for Social Security to improve its own investment performance.

But I think, in a different sense, I would also argue, Congressman, that at least to some extent Chairman Greenspan overstates the case a little bit when he talks about the zero-sum aspect. Because as he recognizes it at a different point in his testimony, the expansion of Social Security's participation in the stock market would be likely to be associated with the reduction in risk premium, risk premiums precisely because Social Security is able to spread risks across all the individuals in the population and is able to spread risks across very long periods of time. That greater spreading of risk represents a kind of economic efficiency gain which turns it into a positive-sum game.

And the last point that I would make is, it is just this: I think our Social Security, I think our overall budget and our overall policies have to be judged on the basis of their impact on national economic performance. But I would hope that we would put first emphasis, as we look at Social Security, on making sure that it is consistent with a sound economy, but, above all, that it works for Social Security beneficiaries. And that is what I think is so important about the approach that the President pursues and why pursuing the opportunity for trust fund investments would be putting Social Security recipients at a very great disadvantage, and forcing them to accept rather painful alternatives to the risk acceptance gains that come from equity investments.

It is a kind of convoluted way of saying it will be better for Social Security recipients if they are invested in equities, and it will probably be a little bit better for the economy, better for Social Security recipients, is good enough for us in the context of an overall economic plan that is conferring a major benefit on the economy by eliminating the national debt.

Mr. BARRETT. Yes, I understand. The other point that he made was that there was a self-policing mechanism in place in a defined-contribution plan. When I put money into a defined-contribution plan, I am watching to see what kind of return I get, and if I am getting a lousy return, I and millions of others will put pressure on the plan to have a better return. In contrast, if I am in a defined-benefit plan, I do not care just as long as I get my check at the end. That was essentially the point that he was making. How do you respond to that?

Mr. SUMMERS. Congressman, I would respond this way: I am glad that you asked that question because I think it is a very important one and it is the answer to the point that I was suggesting about how you are going to have to manage this integrity of investment issue. It is an attempt to answer the point that I was making about how you would have to manage the integrity of investment issue either with a collective or individual approach, and I would answer it in this way:

When you are talking about Social Security, you do not have one individual policeman. You have 250 million policemen in this country, and everything we have seen in the political process—think back to the discussions we had at the time of the debt limit issue; think back to other moments—everything we have seen suggests that if there was any hint that anyone, for any other purpose, was messing with the Social Security Trust Fund, manipulating it, operating it to the disadvantage of its beneficiaries to serve some other individual, the collective recourse and the political appeal of responding to the sense of resentment and outrage that that generates is so strong that it seems to me that it is the overwhelming popularity and salience of the Social Security Program that would provide a far larger resonance to concerns about manipulation of investments than would be the case in an individual.

If you ask individuals who have these kinds of individual accounts without quite elaborate education programs, in lower-wage individuals, in the context of corporations, frankly, there is a lot of confusion about what is going on, a lot of reluctance to notice, and I suspect rather little ability to organize and express concern.

On the other hand, the number of people who are watching every move that the Social Security actuaries make, every move that Social Security trustees take, would, I think, provide enormous reassurance with respect to the integrity of that fund. So I actually think the manipulation risks you can argue might even be smaller in a collectively policed Social Security System than in an individual, with relatively uneducated individuals, police individual account systems.

Mr. BARRETT. If I could, Mr. Chairman, follow up with one question along those lines? I served in the State legislature before I was here. And at one point there was a hot issue in the State legislature about investment of retirement funds in South Africa. This was a time when apartheid was the rule of law in South Africa. And so there was enormous political pressure on the State legislature to withdraw funds from companies that invested in South Africa. How do you see that dynamic at play here?

Mr. SUMMERS. That is the $64,000 or maybe a $64 billion question. I think the answer really goes to three things. One, the statute that we envision would be one that would operate on a permanent to continuing basis. It would not involve specific congressional involvement in investment decisions. Second, the investment decision would not be made by this board, but they would be made by private sector managers. And third, and most important, the rules would say that the investments could only take place in broad-based indices in their entirety, with no scope for picking and choosing which stocks in those indices were to be purchased. And it would be those requirements that would provide insulation from the temptation to make those kinds of choices, just as they provide insulation in the case of Federal Thrift Savings Plan right now.

My own feeling would be, and it is a judgment, that when you are speaking about a program in which almost all Americans have a stake in successful investments, it is likely to be much easier to resist the temptation to engage in those kinds of things than in a situation where it is a much more limited universe of participants and there are a large number of people who are interested in the point made by giving an investment strategy, but who do not have a direct economic interest in the success of the economic strategy, such as would be the case where you have public employees' pensions, but only a very small fraction of a State's voters' pensions that are at stake in a given context.

Mr. BARRETT. Thank you.

Mr. OXLEY. The gentleman from Massachusetts, Mr. Markey.

Mr. MARKEY. Thank you, Mr. Chairman.

My own feeling about that in the drafting of my bill with Mr. Bartlett—I have a 100 percent ADA record and he has a zero ADA record—is that we agreed that it is theoretically possible, but we also understand that that the paradox would set in quite quickly. That is, when someone went after apartheid, someone else would go out for abortion.

From the other end of the spectrum and in the same debate, you would be having votes now on issue after issue which would ultimately lead to a realization that you cannot go down that track. You would be setting up a situation where the Social Security Trust Fund that every American has a stake in would now be used as a vehicle. And I think while some people do not mind the U.N. budget being used or some other vehicle, if you are going to be playing with Social Security, I think both sides will quickly realize it is political dynamite. It is why it is called the political Third Rail, and we just do not think, as a practical matter, that either side would want to go down that course more than the first couple of hours of that debate.

Can I ask you to follow up on something that I asked Mr. Greenspan about? That was the question of what the impact is if the exact amount of money invested in the same common stock index or indexes would have on the national savings debate, if it was invested pursuant to your plan or something that Mr. Greenspan would support. What is the difference in terms of its impact on the savings plan?

Mr. SUMMERS. I think that by and large——

Mr. MARKEY. Mr. Greenspan said there would be no difference. I am just wondering if you agree with that?

Mr. SUMMERS. I think a crucial point would be this: I think this would command very widespread agreement that, by running down the national debt, the President's program would have a substantial increase in national savings. I think that point would command very wide agreement. I think the choice that is made as to how best to invest one's resources is an important choice in a variety of respects, but it is not that its impact is primarily on national savings. That is, my wife and I, if we earn a $1,000, face two choices. One is, are we going to save $100 or are we going to save $200? And then, given that we have to save $100, how much are we going to put in stocks and how much are we going to put in bonds? Changing the amount that we put stocks versus bonds does not change what our savings rate is. But, nonetheless, investing wisely is much better for us than investing unwisely. And that is the nature of our argument with respect to Social Security.

Mr. MARKEY. I agree with that. Now let me ask you a series of questions, if I could, and you would help us by getting this on the record.

With regard to the privately managed individual accounts, the Advisory Council on Social Security has estimated that the administrative costs and fees of a privately managed individual account would average at least 1 percent per year. And other studies show that the mutual funds that invest in stocks have annual fees averaging between 1 and 1.5 percent per year, is that correct?

Mr. SUMMERS. That is very much in line with our own feeling. That 1 percent a year would mean that over an individual's life time approximately 20 percent of their total accumulation would be going to various kinds of administrative costs.

Mr. MARKEY. Now if the fund has been accumulating in an individual account over a 40-year period, were to be converted into an annuity upon retirement, is it not true that there would be an additional fee and expense that could consume an additional 15-20 percent of the savings of the account?

Mr. SUMMERS. I think, to my knowledge, 15 or 20 percent would be a plausible estimate of the load on currently purchased private market annuities. What it would be in the context of any overall scheme would depend upon how that scheme was designed.

Mr. MARKEY. I am just talking about a range here. So then, adding those two numbers together then, 30-35 percent or so of the amounts deposited into an individual account could end up being eaten up by fees and expenses over a 40-year period?

Mr. SUMMERS. It would be possible if the effects would be that large. And, indeed, one study, one analysis that I have been told about that looked at the experience in Britain and built in one other element, which was the costs and one-time fees when competing vendors bid people away. What the individual accounts suggested in that case, at least based on what I was told, that the costs could be as high as 40 to 45 cents out of every dollar.

Mr. MARKEY. So would you not agree, then, that a privately managed individual account would have to substantially outperform a passive index centrally managed fund in order to make up for all the annual fees and expenses and annuitiation costs?

Mr. SUMMERS. Certainly, unless some way could be found of producing a very large improvement in the efficiency over what seems to be the normal practice. In Chile, in fact, Congressman Markey, I am told that on at least one set of estimates the administrative aspects absorbed essentially 500 basis points, or 5 percentage points, of the return that was being earned on the equity investments, which would be pretty much the whole difference between stocks and bonds.

I think I have just been passed a note. I think there is one point that is fair for me to make a little bit more clearly, which is 15 to 20 percent on annuities is, indeed, an estimate of the current private sector costs. But that has a lot to do with the fact that annuities are voluntary, and it is the people who expect to live longest who buy the annuities. In the context of a mandatory system, those annuitiation costs might be somewhat lower.

Mr. MARKEY. But still substantial in terms of the aggregate combined with the other fees?

Mr. SUMMERS. That is right.

Mr. MARKEY. So it is unlikely to happen then? That a fund, an individual fund account with those fees would outperform a passively managed index fund that tracks the S&P 500, because that already routinely outperforms most actively managed equity mutual funds, anyway, with much lower fees and administrative costs than we are going to see in this program?

I think it is associated with centrally managed individual accounts have been estimated by MIT Economist Peter Diamond to consume approximately 7.5 percent of the funds in an average worker's account over the same 40-year worklife, which is better than losing 20 percent of your savings. But such plans still would have to be converted into an annuity upon retirement, would they not?

Mr. SUMMERS. Yes.

Mr. MARKEY. You certainly would not view cutting a check and giving the retiree a lump sum upon retirement—would that be the Clinton administration policy?

Mr. SUMMERS. No, I would certainly envision, we envision a Social Security Program that provides for continued annuitiation, just as current Social Security benefits do, simply supplemented by the benefits of collective investments.

Mr. MARKEY. And I have not heard the advocates of the individual retirement accounts advocating to that either; that is, just handing over the lump sum and not annuitizing.

Mr. SUMMERS. I think there have been some variations, but I think in most cases they envision some annuitiation, that is right.

Mr. MARKEY. Now is it not true that the basic structure and governance of a government-managed private account system would be pretty similar to the Bartlett-Markey bill?

Mr. SUMMERS. That is my understanding.

Mr. MARKEY. So both models would still face roughly the same risks of political interference in corporate governance matters or social investing under such a system? Is that not correct?

Mr. SUMMERS. Indeed, I think that is a fair judgment, which I tried to draw out in my testimony, although there is the question of whether the defined-contribution element would lead to greater discipline versus the discipline inherent in Social Security—being widely watched.

Mr. MARKEY. Would you agree that it would be prudent for us as a committee to consider what additional risks a private account scheme might face?

Mr. SUMMERS. I would think, for all those involved in private account schemes, one would want to consider the risks very carefully.

Mr. MARKEY. I mentioned earlier this morning that when Congress originally created IRAs, they were supposed to be used only for retirement accounts, retirement savings, but now money can be withdrawn from IRAs and used to help purchase a home or pay for educational expenses. Is it not possible that Congress will be no more successful in insulating Social Security private accounts from the inevitable political pressures to make these funds available for similar purposes than it was in limiting the IRA to retirement savings only? Would we not have the same political problem there?

Mr. SUMMERS. There is certainly that possibility, which I think you would be better able to judge than I.

Mr. MARKEY. If there is a recession, is it not possible that Congress would face demands from the public that they be allowed to withdraw their own funds from their own individual accounts right then, to alleviate their immediate economic distress?

Mr. SUMMERS. It could happen.

Mr. MARKEY. And what would then happen to the individual accounts when the beneficiary reaches retirement age? Will we still mandate that they convert into annuities? And if so, what would happen to those who gamble away their savings in riskier investments? Would we wind up, in other words, creating a new generation of stock market notch babies where the Federal Government would have to move in or be pressured to move in to prop up those that were now in a more disadvantageous position as pensionists?

Mr. SUMMERS. Congressman Markey, that seems to me to be an important issue that should be addressed to advocates of particular individual accounts proposals to see how they would work through that.

Mr. MARKEY. Should we force, would we be in a position where we would force retirees with serious medical problems or terminal illnesses to accept a lifetime annuity or else they will not be able to fully enjoy it when what they really want is a lump-sum payment of their own money right now? How are we going to say no to those people with terminal illnesses, if they are in individual accounts? How do we tell them, no, that we are not going to do it—in terms of political pressure because it seems to be the big issue here?

Mr. SUMMERS. Many of these are good questions to address to what I suspect will be other witnesses before this committee who are in the position of advocating individual account proposals because, certainly, as we thought about them, those are the kinds of issues that would certainly have to be addressed.

Mr. MARKEY. Everyone who testifies from that seat, Mr. Summers, is an expert on what the governing class will do under pressure. So I am just giving you the same opportunity to prognosticate what our actions will be. We are a stimulus response institution and there is nothing more stimulating than public pressure on us in an election year. So everyone is free to sit down there and speculate as to what we would do.

And what I would argue, I guess, is that a preconstructed system would ensure, at least to the best of our ability, that the accounts would be protected politically. They we would be far better off, in terms of the gambling aspects of going into the stock market, and it centrally managed, and having the government there to still guarantee that annual income to retirees. Because you still only know the protocol pressure issue. By going to the individual retirement accounts, you still wind up with all kinds of pressures from constituents along the way.

Anyway, thank you so much, Mr. Summers, for your testimony today. It was very helpful.

Mr. Chairman, thank you for your indulgence.

Mr. OXLEY. The gentleman's time has expired.

Mr. SUMMERS. And BC is behind 47 to 18 at the half to Syracuse. So I have no reason to leave and I will go another round if you want to.

Mr. OXLEY. No, I don't want to hear any more moaning about the coach and the star player going to Ohio State. We have heard enough about that.

Mr. Summers, thank you so much for appearing before the panel today. It was most informative.

Mr. SUMMERS. Thank you very much for the opportunity, and I hope our comments were of use to you.

Mr. OXLEY. Very good. Thank you very much.

The subcommittee stands adjourned.

[Whereupon, at 2:45 p.m., the subcommittee adjourned.]