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Statement of

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Chairman

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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 <u>own</u> 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 (OASI) 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; 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 4 to 5 percent of taxable payroll.

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 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. 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 social security must be offset by a reduction in returns earned on private portfolios, which represent, to a large extent, funds 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 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 $3-3/4 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.