TESTIMONY OF

MICHAEL TANNER

DIRECTOR, CATO PROJECT ON SOCIAL SECURITY CHOICE

before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON SECURITIES AND INVESTMENT

JUNE 14, 2005

Mr. Chairman, distinguished Members of the Committee:

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

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

In particular, regarding the subject of this hearing, economic theory holds that private capital investment should provide a higher rate of return than a mature PAYGO Social Security system. If one accepts the Social Security Administration's assumptions about future bond and stock returns, a balanced portfolio (50 percent stocks, 30 percent corporate bonds, and 20 percent government bonds) could be expected to yield a return of 4.9 percent.

Subtracting 25 basis points of administrative costs provides a net yield of 4.65 percent. Shifting the mix slightly in favor of equities should raise the expected return to roughly 5 percent. This clearly exceeds the return available from Social Security, and also significantly exceeds the offset interest rate suggested under the president's reform proposal.

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

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

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

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

- **Simplicity and Transparency.** Workers should clearly understand where there money is going and what their options are. Where personal account plans have encountered difficulties, such as in Britain, it has been primarily do to overly opaque or complex schemes.

- **Balancing Return and Risk.** While market returns can be expected to exceed Social Security returns, markets are not risk free. In particular, they offer increased volatility. In addition, many of the new investors brought into the market through personal accounts will be inexperienced. A personal account investment plan must offer these individuals some degree of protection without stifling consumer choice, over regulating markets, or unduly restricting the potential for positive returns.

- **Keep Administrative Costs Low.** While regulation of account fees would be unwise, accounts should be designed in ways that minimize administrative costs. SSA estimates that accounts would cost 25-30 basis points to administer. This seems like an entirely reasonable target.

- **Limit government involvement in investment decisions**. Decisions about the investment of the accumulating retirement funds should be left to private markets and insulated from government interference as much as possible.

- **Avoid increased employer burden.** Every effort should be made to avoid any new burden on employers, particularly small employers. Possible sources of additional employer burdens would include higher tax payments, greater complexity in tax calculations, more extensive record-keeping requirements, or a requirement to report information more frequently.

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

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

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

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

- A small number of index funds each composed of a different type of investments. For example, the Federal Thrift Savings Plan, which President Bush has cited as an example, offers a fixed income fund, a common stock fund, a "small cap" stock fund, a government bond fund, and an international stock fund. The Chairman's proposal, S 540, is also built around this model.

- A small number of balanced funds, each composed of a different mix of stocks, government bonds, corporate bonds, and cash. This option is included in HR 530 among others.

- A lifecycle fund that automatically adjusts the mixture of investments as a person ages. Younger workers would be more heavily invested in stocks, with the mix changing more heavily to fixed income assets as the worker nears retirement. The president has raised the possibility of this option, as has the Chairman. And I believe it is included in S 857, sponsored by Sen. Sununu.

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

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

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

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

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

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

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

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

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

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

Thank you.