Statement of Representative Peter DeFazio (D-OR)
Social Security Subcommittee of the House Ways and Means Committee
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## Introduction

Chairman Shaw, Ranking Member Matsui and other members of the subcommittee, I appreciate the opportunity to testify today about the future of Social Security.

I am in the middle of a series of 15 town hall meetings I've been holding throughout Southwest Oregon to discuss Social Security with my constituents.

If there's one thing I want those who attend my town hall meetings to take away from those gatherings it's that Social Security is NOT in crisis. It is a fundamentally sound program that can remain so for the next 75 years and beyond with only minor changes.

If there's one thing I would like the Members of this Subcommittee to take away from my testimony today, it's that when residents of the 4th District of Oregon hear the truth about what privatization of Social Security means, they oppose it.

I will go into the specifics shortly, but at the outset of my testimony I would like to put in a pitch for my own plan to ensure the solvency of Social Security. I have introduced legislation, H.R. 3315, the "Social Security Stabilization and Enhancement Act." The Social Security actuaries have certified that my legislation would restore 75-year solvency to the program. And, just as importantly to me, the reaction of Oregonians at my town hall meetings has been favorable.

I would urge this subcommittee to seriously consider my proposal as a viable alternative to the wholesale dismantling of Social Security that privatization represents.

## The Social Security Trust Fund and the Financial Challenges Facing Social Security

As you know, currently, Social Security is collecting more in payroll taxes than is necessary to send checks to beneficiaries.

Congress made a conscious decision in the early 1980s, pursuant to a recommendation by the Greenspan Commission, to boost payroll taxes far above the level necessary to fund current benefits in order to build up reserves for when the Baby Boom generation began to retire.

These excess payroll taxes are being credited to the Social Security Trust Fund and then invested in government bonds that pay interest to the Trust Fund. The Trust Fund already has assets of more than $ 1 trillion, and will grow to around $6.5 trillion by 2024.

Some in Congress and the current Administration have claimed that the bonds held by Social Security are not assets, but rather are "worthless IOUs."

When you deposit money in your savings account at your local bank or credit union, the money doesn't just sit there waiting for you to retrieve it. The financial institution loans the money out to other customers and makes money by charging interest. But, the institution also has an obligation, when you return to withdraw some of your money, to have the resources to cover that transaction.

Similarly, the money contributed to Social Security is not stacked up and locked away until a worker is ready to collect benefits. Rather, surplus Social Security funds have been used to fund other government programs or, more recently, at least until President Bush and Republicans in Congress created a fiscal mess with last year's tax cut, to pay down debt. Yet, no matter what the surplus has been used for, the Social Security Trust Fund has always received a U.S. Treasury bond in return.

U.S. Treasury bonds are the safest investments in the world. That is why, when there are periodic global financial crises, investors flee for the safety and soundness of U.S. Treasury bonds.

Because they are the preferred choice of investors around the world, it should be clear that U.S. Treasury bonds represent real financial assets. If some in Congress and the Administration continue to insist otherwise, then they've got some explaining to do to investors around the world, in which case I fear for the stability of our nation's financial system.

For those who don't believe the Trust Fund exists, or don't believe it holds real assets, I would urge them to look at page 19 of the latest Social Security Trustees report. The chart on page 19 lists the current assets of the Social Security Trust Fund. As the chart shows, the Trust Fund holds bonds with varying maturity dates and varying interest rates (6.125 percent up to 10.375 percent). Clearly, the Trust Fund represents real assets.

In fact, the bonds held by the Social Security Trust Fund state explicitly, "The bond is incontestable in the hands of the Federal Old-Age and Survivor's Insurance Trust Fund. The bond is supported by the full faith and credit of the United States, and the United States is pledged to the payment of the bond with respect to both principal and interest."

That said, I agree that demographic changes – a growing number of retirees, proportionately fewer workers, and longer life expectancy – create challenges for Social Security. But these financial challenges are entirely manageable without abandoning the concept of social insurance and the best anti-poverty program ever devised by the federal government.

In 2016, the payroll taxes coming into Social Security will be insufficient to cover all promised benefits. The Social Security Administration (SSA) will then begin to draw on the interest earned by the Social Security Trust Fund to help pay full benefits.

In 2025, incoming payroll taxes plus the interest income from the Trust Fund will be insufficient to pay all benefits. The SSA will then begin redeeming bonds held by the Social Security Trust Fund to cover full benefits.

As the Social Security system begins to redeem these bonds over the next several decades, the government has to find the money to honor this debt. There is more than one way to do so.

The most obvious way is to reserve current Social Security surpluses to pay off our massive national debt, thus saving hundreds of billions of dollars a year in interest payments that could then be devoted to Social Security.

There had been consensus until last year in Congress on using Social Security surpluses to pay down debt. Unfortunately, President Bush and Republicans in Congress rammed through a $2 trillion tax cut last year under the misguided assumption that a projected $5.6 trillion 10-year surplus somehow represented real money that could be returned to taxpayers with no negative fiscal consequences.

Now, not only has the promise to pay down debt been broken, thus burdening our nation's children with a crushing debt they didn't create, but the bipartisan consensus to reserve Social Security surpluses for only paying down debt and shoring up the program has been abandoned.

The budget recently submitted by President Bush would spend $1.5 trillion in Social Security money over the next decade. Essentially, the President is funding tax cuts that overwhelmingly benefit those making over $373,000 a year by shifting working Americans' Social Security money into the bank accounts of our nation's wealthiest individuals. That is totally unacceptable.

The federal government could also simply issue new debt to investors and use the cash raised to cover benefits.

Again, however, the first two options have been made more difficult by the fiscal irresponsibility of Republicans in Congress and the current Administration.

Another option to find the resources to redeem the bonds is to collectively invest a portion of the Trust Fund in equities other than federal debt. Diversification would increase liquidity and has the potential to increase the resources in the Trust Fund through higher rates-of-return without the risk inherent in a privatized system. I will have more to say about collective investment in a minute.

The final key date for Social Security is 2038. In 2038, all of the bonds in the Trust Fund will have been redeemed, and Social Security will rely solely on incoming payroll taxes to fund benefits.

In other words, without any changes whatsoever, for the next four decades, Social Security will be able to pay 100 percent of promised benefits.
However, even after 2038, Social Security will never be "bankrupt" in the sense that it couldn't pay any benefits whatsoever. If Congress sat on its hands and made no changes for the next four decades, under current projections, the program would still be able to cover 70-75 percent of promised benefits in perpetuity because of the payroll taxes flowing in from workers' paychecks.

Therefore, we are here today discussing how best to plug that roughly 25 percent gap between expected revenues and benefits.

**Uncertainty in Long-Term Projections**

Keep in mind, however, that even that projected deficit is highly speculative since it is very sensitive to underlying economic and demographic assumptions.

As former Social Security Commissioner Robert Ball wrote in his book *Straight Talk About Social Security*, “Think how things would have turned out if, in 1923, during the Administration of President Harding, experts had tried to forecast population growth and the movement of wages and prices up to 1998. Among other things, they could not have anticipated the impact of a worldwide depression, a second global war, and an unprecedented cold war.”

In their intermediate assumptions, the actuaries project economic growth over the next 75 years will average only around 1.5 percent, or roughly half the average growth rate over the previous 75 years, even with the Great Depression figured in. I would argue that future presidents and Congresses are not going to sit by and let the economy grow at a dismal 1.5 percent for decades. If they do, then our nation will probably have bigger problems to deal with than what to do about Social Security.

Leaving aside for a minute the glaring inconsistency between this low growth rate and privatization proponents’ mantra that private accounts will yield at least a seven percent rate of return, it is important to understand that slight changes in assumptions can shrink the projected deficit in Social Security significantly.

According to the Social Security actuaries, if economic growth is just one percent higher, which would still be below the historic average, then half of the projected long-term deficit disappears. If economic growth is two percent higher, or in other words, right around the historic average, then the deficit in Social Security virtually disappears.

The story is similar if other economic or demographic assumptions, such as wages, productivity or life expectancy, are different that what is currently projected.

Just as fundamentally, while privatization proponents predict disaster because of the decreasing proportion of workers to retirees, arguably the more important measure is the ratio of workers to overall dependents in society, which includes retirees, children, and non-working adults.

As Robert Reischauer and Henry Aaron note in their book *Countdown to Reform*, “While the proportion of the population that is elderly has risen and will increase further, the proportion of children and nonaged adults who are not working for pay has fallen over the past three decades and is projected to fall further in the future. Consequently, the number of people each worker will support is projected to rise only modestly – approximately 6 percent – between now and 2040, even though the number of elderly will soar. The number of economically inactive members of the population per 100 workers was much in the past (156 in 1960) than it was in the mid-1990s (103 in 1995) or than it is projected to be in the future (115 in 2040).”

All of these caveats I’ve raised are not intended to lead to the conclusion that Congress should do nothing. Obviously, it is prudent to plan for the solvency of Social Security with a lot of lead-time using relatively conservative assumptions (though privatization proponents should consistently apply these conservative assumptions when scoring their own plans).

But, a serious look at the assumptions underlying the projected deficit does lead me to the conclusion that the hysterical cries that Social Security is in crisis are simply false, and privatization is not a necessary or desirable direction in which to take Social Security.

**The DeFazio Plan**

So how can we ensure the long-term solvency of Social Security while keeping the program intact? As I mentioned at the beginning of my testimony, I have offered legislation, H.R. 3315, the "Social Security Stabilization and Enhancement Act," that I believe could serve as a model. There are three primary features of my bill: making the Social Security payroll tax burden more fair, boosting benefits for the most vulnerable seniors, and diversifying Trust Fund investments.

1. **Payroll tax cut**: H.R. 3315 exempts the first $4,000 in wages from the Social Security payroll tax. This exemption would cut Social Security payroll taxes by more than 11 percent for an individual earning $35,000. The exempt wages would still be included for purposes of calculating benefits.

2. **Lifting cap on wages subject to Social Security payroll tax**: Currently income above $84,900 is not subject to the Social Security payroll tax. By contrast, all wages are subject to the Medicare payroll tax. My legislation would merely treat wages the same for Social Security as for Medicare by lifting the cap on wages subject to the Social Security payroll tax. This change would only impact the wealthiest 5 percent of Americans. The cap would be retained for the purposes of computing benefits.

3. **Increase benefits up to 5 percent for those over age 85**: Those over age 85 are highly vulnerable to poverty, particularly women who are widowed. My legislation would provide for a modest increase in benefits of up to 5 percent.

4. **Allow diversification of Trust Fund investments**: H.R. 3315 sets up the Social Security Investment Oversight Board (SSIOB). Members of the SSIOB would serve lengthy, staggered terms. The SSIOB would be responsible for selecting private fund managers to invest up to 40 percent of the Trust Fund on behalf of Social Security beneficiaries. When the Social Security actuaries scored my plan, they assumed half of the Trust Fund assets eligible for diversification under my plan would remain invested in U.S. Treasury bonds, while the other half would be invested in corporate equities. Investing would be limited to broad-based index funds, therefore eliminating the danger of picking and choosing individual stocks. H.R. 3315 also requires that investing be done solely in the fiduciary interest of Social Security beneficiaries. This, along with using index funds, would help prevent Congress from interfering in investment decisions.

   The collective investment provisions I've written into my legislation are consistent with those recommended by R. Kent Weaver, a senior fellow at the Brookings Institute, in his testimony last September before the President's Social Security privatization commission. Noted Social Security experts like Robert Ball, Henry Aaron, and Robert

Reischauer have also called for collective investment.

Mr. Weaver noted several important advantages collective investment enjoys over individual accounts.

He testified, “First, by pooling investments and keeping transaction, marketing and reporting costs to a minimum, collective investments can lower the costs of investing funds dramatically and produce higher net returns than individual retirement savings accounts.

“A second advantage that collective trust fund investment has over individual accounts is that it lowers information costs for consumers, as the costs of evaluating alternative investments are spread over huge groups.

“A third important advantage that allowing Social Security trust fund equity investments has over individual accounts is that doing so would not undermine or erode the defined benefit structure of Social Security, which provides a predictable retirement income that spreads the risks of fluctuating asset values and annuity prices across the population and over generations.”

To Mr. Weaver’s observations about the benefits of collective investment, I would add two of my own: collective investment allows for the potential of increased rates-of-return on investments without the risk of individual accounts. It is much easier for private fund managers to ride out even a lengthy downturn in the stock market than it is for an individual nearing retirement.

In addition, collective investment has the potential to increase national savings. Under a system of individual accounts, it is reasonable to expect that as individuals begin to accumulate savings in their privatized accounts that they may reduce savings elsewhere, such as in their 401(k)s or IRAs. To the extent they reduce these other sources of savings, overall national savings declines. By contrast because individuals would not see the accumulation of wealth through collective investment, they would not have an incentive to reduce savings elsewhere. Therefore, collective investment will likely have a greater positive economic impact than privatization.

I know some of my colleagues have raised concerns about the federal footprint that would be left in the stock market if we allow collective investment of a portion of the Social Security Trust Fund.

It is important to keep in mind that state and local governments in the United States already own substantial private assets, which has not endangered the efficiency of financial markets. As the Center on Budget and Policy Priorities noted in a February 26, 2001 report, “At the end of the third quarter of 2000, state and local pension investments in private assets (including stocks and bonds) amounted to 28 percent of the U.S. Gross Domestic Product (GDP), and state and local pension investments in corporate equities amount to almost $2 trillion, or 19.5 percent of GDP. This scale is likely to be well beyond that which the federal government would undertake if a portion of the Social

Security trust fund were invested in private markets."

The Federal Thrift Savings Plan (TSP) is another example of a public entity successfully investing in private assets.

As I mentioned previously, the Trust Fund investment envisioned by my legislation would be done by the private sector, and would be limited to broad index funds. However, additional protections could be written into law that should satisfy all but the most ideologically rigid Members of Congress.

For example, we could limit the size of any one Social Security investment fund to roughly the size of the largest private investment fund, which is currently Fidelity Investments with 3.3 percent of domestic equities. If a Social Security investment fund reached this size, it would not receive any new money and a new fund would be created and privately managed by a different firm.

Some have also raised the concerns about how voting rights for shareholders would be exercised under a system of collective investment. There are a variety of ways to address this concern. The simplest would be to prohibit the shares held by the Trust Fund from being voted by fund managers at all. Fund managers could also be required to vote the shares in proportion to other shareholders' votes, thus not affecting the final outcome.

A third, more controversial, option would be to require the fund managers to vote the shares in the fiduciary interest of shareholders. While there used to be a fair amount of shareholder activism by state pension funds, this seems to have dissipated. A recent study by Alicia Munnell of Boston College shows that state funds have moved away from such practices and have earned returns that compare favorably to those of private retirement funds.

5. **Increase years of earnings used to compute benefits from 35 to 38**: Consistent with a recommendation of many non-partisan analysts, H.R. 3315 would increase the years of earnings used to compute benefits from the 35 highest years to the 38 highest years of earnings. However, my legislation also allows for three child-care dropout years, so individuals who stay home to care for children are held harmless by the increase.

**The Pitfalls of Privatization**

Let me briefly touch on a number of the pitfalls of privatization. I believe proponents of privatization need to be much more honest with the American people about the implications of privatization. It is simply not possible to create a system of private individual accounts using existing payroll tax revenue and still protect Social Security recipients from benefits cuts. Spending tens of millions of dollars in Social Security money to send beneficiaries an embossed certificate promising to protect their benefits (which the Congressional Research Service notes would not be legally enforceable) cannot get around the fundamental fact, as the President's privatization commission acknowledged in its report, that privatization means large cuts in existing Social Security benefits.

*Transition Costs*

Because the vast majority (70-80 cents of every dollar) of payroll taxes coming into Social Security go out immediately to pay benefits, diverting two percent of payroll taxes (or more depending on the privatization plan) creates a huge gap in financing of $1 trillion over the next ten years and $3 trillion over the next twenty.

Some plans, including those advocated by the President's privatization commission, envision some sort of general revenue transfer to fill this gap. However, as I noted earlier, the surplus general revenue that theoretically could have been used for such a transfer no longer exists, thanks primarily to last year's tax cut.

Another option to close the financing gap would be to raise taxes. However, that would result in double-taxing young people: once to fund benefits for current recipients, and again to fund their own individual account. A lot of young people believe privatization would be good for them, but in reality, it would actually represent more of a financial burden.

A third option to close the gap is to cut benefits. I will discuss that option in a minute.

The bottom line is that a system of private individual accounts does absolutely nothing to ensure the solvency on Social Security. In fact, diverting payroll tax revenue to private accounts actually accelerates the financial challenges facing Social Security. Diverting two percent of payroll taxes would accelerate the projected insolvency of the Trust Fund from 2038 to 2024 – 14 years sooner.

*Benefit Cuts*

I have never seen an honest privatized Social Security plan that did not include massive benefit cuts. Sometimes these cuts are explicit, and sometimes they're hidden. But, that doesn't change the reality that the cuts would be necessary and real, and would cause severe hardship for beneficiaries.

For example, the President's privatization commission proposed a disguised increase in the retirement age and slyly proposes tying initial benefit levels for future retirees to the growth in prices, rather than wages, as is now the case. As Ranking Member Matsui has noted, "Wages rise faster than prices, and reflect the growth in the standard of living. If this change were adopted, retirees could not maintain the standard of living in retirement that they had earned during their working years, but instead would fall back to the reduced standard of previous generations."

The Center on Budget and Policy Priorities has estimated that so-called "price-indexing" would reduce benefits by 40-50 percent. These benefit reductions would apply to all Social Security beneficiaries, including the disabled, widows, and children.

*Rates-of-Return*

In order to make privatized individual accounts sound attractive, privatization proponents assume very high rates-of-return from an individual's investment in the stock market. But at the same time, in order to claim a crisis in Social Security, they create a false sense of alarm by assuming future economic growth will be slow. They can't have it both ways.

Proponents have not been able to show, indeed, have not even tried to show, how the stock market would be able to yield seven percent returns in the future when economic growth is projected to be only around half of what it's been in the past. Many experts, including Peter Diamond of the Massachusetts Institute of Technology and Dean Baker of the Center for Economic and Policy Research, predict the stock market is likely to provide only around a 3.5 percent rate of return in the future given current levels of price-to-earnings ratios and projected economic growth rates. Mr. Diamond's research shows the only way stocks could yield seven percent in the future is if the market dropped in value by half first! I don't hear privatization proponents acknowledging the market needs to drop by 50 percent in order for their plans to add-up. I imagine that would make their plans sound less attractive to the American people.

Privatization proponents also downplay the risk of investing in stocks. While the market has had a general upward trend, there were fifteen years in the past century in which the value of the stock market fell by more than 40 percent over the preceding decade.

Or as the General Accounting Office (GAO) noted in an April 1998 report, "Although the 30-year average of the S&P 500 since 1970 consistently outperformed the Treasury returns credited to the Social Security trust fund, the 10-year moving average of the S&P 500 underperformed the trust fund's Treasury returns at times…In fact, nominal stock returns were less than the Social Security trust fund's annual yield in 17 years from 1950 to 1996 – more than 35 percent of the time."

GAO also noted in a June 1999 report, "Actual nominal (non-inflation adjusted) returns for large company stocks varied widely from the annualized average return over long periods and have ranged from a low of minus 25.6 percent in 1974 to a high of 52.6 percent in 1954…over the past 70 years or so, equity returns were negative in nearly 1 out of every 4 years."
Gary Burtless of the Brookings Institution has modeled how individuals would have faired under a privatized Social Security system, had individuals invested in stocks since the beginning of the program. What Burtless found should give advocates of privatization pause. According to this research, the initial wage replacement rates for workers ranged between 20 percent and 110 percent, with an average rate of 53 percent. As his Brookings colleague Mr. Weaver noted in his testimony before the privatization commission, "This difference of more than 5 to 1 in replacement rates is a fatal flaw for a program designed to ensure a basic income level."

If a worker, dependent on an individual account retired during a market downturn, they would see a substantial reduction in their retirement earnings. Investing the Trust Fund collectively as I've proposed would limit the risk for individuals and offers the ability to weather even a sustained market downturn.

Further, as analysts like the GAO (in an August 1999 report) and the Center on Budget and Policy Priorities have pointed out, a simple rate-of-return comparison can be highly misleading unless a number of factors – like transition costs, disability and survivor's benefits, administrative costs and increased risk associated with privatization – are also incorporated into the comparison. These factors all decrease potential rates-of-return under privatization.

It is also important to keep in mind that the rate-of-return argument is essentially irrelevant to a social insurance program like Social Security. You don't complain if your rate-of-return on your fire insurance is zero, because that means your house didn't burn down. Social Security is an insurance program, not a get rich quick investment scheme. It provides the equivalent of $300,000 in life insurance and $200,000 in disability insurance in addition to a retirement benefit. Equivalent private sector life and disability benefits are often beyond the reach of working Americans.

*Administrative Costs*

Administrative costs under the current Social Security system are less than one percent of total expenditures. By contrast, under a privatized system, individuals would likely lose at least 20 percent of their benefits to administrative costs. Administrative costs in the partially privatized system in Britain have reduced the account of the typical worker by 36 percent. While it's true that administrative costs can be lowered by restricting investment options and similar sorts of measures like those proposed by the privatization commission, doing so goes against privatization advocates' mantra of individual choice. Even if one weighted down a private accounts system with a bunch of provisions designed to minimize administrative costs, there is zero chance such a system could compete with the administrative efficiencies available under the current system or under a system allowing for collective investment.

*Impact on Employers*

An often over-looked problem with privatization is the impact on employers, particularly small businesses. Eighty percent of the workforce earns less than $40,000. Forty-two percent of the workforce earns less than $15,000. Eighteen to twenty percent of the workforce earns less than $5,000 (of these, many work for 4-5 different employers per year.)

The 25,000 largest employers file reports with the IRS every day by electronic deposit. All of these deposits are recorded in the general fund of the Treasury, which then transfers them to SSA on a daily basis. Other employers, depending on size, report every two weeks, every month, or, for the smallest employers, every quarter (4 million employers have 10 or fewer employees).

However, all of these transfers are aggregate payments. There is no effort to distinguish between what payments are made on behalf of which employee. Even those filing quarterly don't have to match payments to specific workers.

The only time employers have to tell the government about payments and earnings made on behalf of individual employees is when they file W-2s. These aren't given to the government until several months into the year.

This is not a problem for a defined-benefit program such as Social Security because an individual's benefit level does not need to be reconciled until retirement. However, this does become an issue for defined contribution plans in which individuals want to track every dollar contributed in their name.

There is a considerable lag – as much as seven to 22 months – between the time taxes are collected and the funds are credited to an individual's name by the Social Security Administration (SSA).

Over 240 million W-2s are filed per year on behalf of 140 million people (35-40 percent of workers - 58 million - have annual earnings reported to SSA from more than one employer).

Thirty percent of W-2s are still filed on paper by 6.5 million employers. Eighty-five percent of employers still submit forms on paper.

Only 100,000 employers provide data to the government on magnetic tape (the easiest format to deal with).

Fifteen million individuals file as self-employed, who have their own unique reporting system through the Internal Revenue Service (IRS). The IRS then reports to the SSA at a later date. Further complicating matters, one-half of the self-employed also work for employers that send a W-2 to the SSA on their behalf.

March-September is for processing by the Social Security Administration (verification of names, wages etc.).

Five percent of W-2s have information that doesn't match and can't be corrected electronically. SSA then begins corresponding by paper with employers

After this, SSA is left with approximately 2 percent (4.5-5 million W-2s) of what is submitted that can't be reconciled. This error rate would probably not be acceptable under a system of private accounts.

About 650,000 employers go out of business or start new businesses each year (represents a 10 percent turnover rate). This makes it even more difficult to reconcile information.

Adding new administrative tasks, such as more frequent reporting requirements, could put a substantial financial and time burden on employers and increase the costs for a system of private accounts.

According to the results of a survey by the Employee Benefits Research Institute (EBRI) study:

> Employers do not want to have to implement or administer a new system of private accounts. On average, employers were only willing to spend $400 total on all aspects of implementation. Eighteen percent consistently said they were willing to spend nothing.

In addition, most small businesses have little or no experience administering 401(k) plans. Only 10 percent of small businesses offer a pension plan.

Privatization proponents cannot continue to gloss over the substantial burden a privatized system of individual accounts would place on our nation's businesses, particularly small businesses.

*Public Education Challenges*

Privatization will obviously create winners and losers. A significant public education component would be required to ensure individuals, particularly lower-income individuals, fully understood the choices available to them. Keep in mind that misleading marketing in the partially privatized British system led millions of pensioners to invest disadvantageous ways. This led to sanctions against fund managers and demands for a multi-billion government bailout of pensioners.

According to the National Center on Education Statistics, 21 percent of the adult population has only rudimentary reading and writing skills (at or below the fifth-grade level).

As the former Chairman of the Securities and Exchange Commission, Arthur Levitt, put it, there is a wide gap between financial knowledge and financial responsibilities.

A variety of surveys by the SEC, the Securities Industry Association, and the Vanguard Group have shown this disconnect. These studies have shown:

47 percent of 401(k) plan participants believe stocks are a component of money market funds;

55 percent thought they could not lose money in government bond funds;

Less than half of all investors correctly understood the purpose of diversification;

Over half of all Americans do not know the difference between a stock and a bond; and

Only 16 percent said they have a clear understanding of what an IRA is.

Privatization advocates do a disservice to informed debate when they pretend that all Americans will win if they play the market. That clearly is not the case. And, those who have the most to lose by dismantling the guaranteed safety net offered by Social Security - lower-income Americans - are the same people who are most ill-prepared to make critical investment choices.

*The Chilean Model*

Finally, a few individuals who have attended my town halls have wondered about the privatized Chilean system that privatization advocates have touted as a model for the United States. Let's take a closer look at the Chilean system.

Either advocates of the Chile privatization model haven't actually studied the details of the Chilean system, or they believe America's seniors deserve a more volatile retirement system with lower benefits and larger profits for private money managers.

The first thing to understand about the privatized Chilean pension system is that it was imposed by a military dictatorship in 1981. Tellingly, however, the dictatorship protected one class of citizens, the military, which continues to receive pensions under the state-sponsored pension system.

The privatized system in Chile has also been less far less efficient than the previous social insurance system. Adding up the pensions under the privatized system and those still being paid under the previous system, along with cost of the minimum pension guarantee (the government subsidizes the private accounts if the rate of return you received from the market is too low), and the privatized system is at least three times as costly to run as the social insurance system it replaced.

While the early returns on private accounts looked high, the returns were primarily attributable to one-time events - the selling-off of state enterprises and extremely high interest rates - with no relevance to the returns possible in the United States. In 1995, average returns fell to negative 2.5 percent, and have averaged only 1.8 percent over the last several years.

Further, the administrative costs of the privatized Chilean system have run around 15-20 percent of annual contributions. By contrast, the administrative costs of Social Security in the United States are less than one percent. Commissions to private money managers in Chile reduced the average return in the early years of privatization from 12.9 percent to a mere 2.1 percent. That helps explain why the profit margins of the money managers averaged more than 22 percent.

There are also problems with underreporting of contributions by businesses and individuals as well as inadequate coverage from private pensions (40 percent of beneficiaries require additional assistance).

**Conclusion**

Social Security is a fundamentally sound program that offers guaranteed, inflation-protected, annuitized benefits for retirees, the disabled, and survivors. These benefits simply cannot be duplicated by the private sector. While the program faces modest financial challenges decades in the future, those challenges can be managed without dismantling the current system via privatization.