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Social Security Reform: The Issue of Individual Versus Collective Investment for Retirement

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Summary

Of the many issues raised in the current Social Security debate, perhaps none is more complex than whether and how the nation's financial markets might be used to reform the system. In its simplest form, the question of how it might be done has brought attention to two possible approaches: (1) having individuals invest some or all of their Social Security contributions directly in the markets or (2) having a government appointed entity invest some of them in the markets for the Social Security trust funds. The current system is a collective one; its resources are shared in the sense that it does not set aside a person's Social Security taxes for his or her own use. Social Security benefits are based instead on a person's "average" earnings and most of a person's taxes are used to pay the benefits of today's recipients. Any surplus is recorded to the trust funds for the potential future benefit of all recipients.

Proponents of a more individualized system of personal accounts say that taking people's money and using it to pay for someone else's benefits is unfair. They argue that it would be better if people invested some or all of their own money for their own retirement. In this way, they contend, people would feel they had gotten what they paid for based on their own decisions. If they want to take more risks, they should be able to. If they want to be more cautious, they could do that too. Simply stated, individual account proponents argue that people should have more choices. Proponents of the current system say that it protects society, as much as the individual, against poverty. They argue that in the absence of Social Security, widespread destitution would exist among the aged and disabled. They do not dispute the claim that people should be able to choose how to save and invest, but through their personal savings and private pensions, not through Social Security.

Elements of both camps say that investing in the financial markets can help make the nation's retirement system more secure. Proponents of the current system who do so (recognizing that not all do) contend that the higher yield from investing a portion of the trust funds in the markets could help reduce the system's long-term funding problem. Proponents of personal accounts generally distrust the government to invest without interfering with private enterprise and would prefer that people grow their own accounts to supplement Social Security, perhaps allowing future Social Security benefits to be constrained enough to make the system solvent. While shoring up the system is the catalyst for discussion, much of the debate emanates from a philosophical conflict about how much the government needs to be involved in securing retirements. Proponents of the current system argue that to adopt a more individualized system, where how well one invests becomes critical to one's retirement well being, would be too big a risk for many of society's economically vulnerable people. They see the current program as a necessary role for government in assuring a minimal standard of retirement income. Others contend that society has changed and is much more capable today than in the 1930s of sustaining a system that does not rely on a mandated transfer of income from workers to recipients. They argue that given adequate incentives, perhaps even a mandate, people could effectively save the same Social Security tax dollars on their own, possibly achieving greater economic returns than afforded by a politically-driven, governmental system.

Contents

Overview of the Issue 1
The Case for Collective Investment 5
The Case for Individualized Accounts 17

Social Security Reform: The Issue of Individual Versus Collective Investment for Retirement

Overview of the Issue

While a myriad of issues have been raised in the current Social Security debate, perhaps none is more complex than the question of whether and how the nation's financial markets might be used to reform the system. In its simplest form, the question of how it might be done has brought attention to two possible approaches: (1) allowing or requiring individuals to invest some or all of their Social Security contributions directly in the markets or (2) having the government or some quasi-government entity invest them for the collective good of all recipients.

The issue may sound academic, but it's not. At its core, it is not about how retirement investments are made or what the investments are. It is about who bears responsibility for the decisions that are made. It is about individual versus collective preparation for retirement. Who makes the investments? Who bears the risks? Who reaps the rewards? Individuals or society in general?

The current Social Security system is a collective one; its resources are shared broadly amongst those who are "insured." Since participation in the system is mandatory, "insured" means most people who work. Its purpose is to minimize the risks of destitution in old age or because of disability for all who participate as well as their dependents. Its resources are shared in the sense that it does not set aside a person's Social Security taxes for his or her own use. Instead, those taxes are pooled for the collective use of all recipients. Simply stated, there is no savings account to which the taxes that each individual pays are credited. The Social Security Administration keeps a record only of a person's earnings, not of his or her taxes. Moreover, the amount a person pays does not determine how much he or she receives; Social Security benefits are based instead on an "average" of a person's career earnings and the formula used is deliberately tilted to favor low lifetime earners.[1] Most of a person's Social Security taxes are used to pay the benefits of today's recipients. Any surplus is recorded to the Social Security trust funds for the

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[1] Benefits are computed by applying a three-step formula to a worker's "average indexed monthly earnings" (AIME) calculated using as many as 35 years' worth of earnings. For workers reaching age 62 in 2000, monthly benefits are the sum of 90% of the first $531 of AIME, 32% of the next $3,202, and 15% of the remainder. Both the earnings used to compute the worker's AIME and the so-called "bend points" in the benefit formula ("$531" and "$3,202") are indexed to reflect growth in average wages in the economy. For retirees, each year's earnings are indexed from the year they were earned to the year the worker reaches age 60 (earnings at age 60 and beyond are included in the calculation at their nominal value).

potential future benefit of all Social Security recipients.[2] And perhaps most pertinent to this discussion, neither the individual nor the trust funds' account manager (who by law is the Secretary of the Treasury) makes investment decisions about what to do with Social Security funds.[3]

Proponents of a more individualized system say that the current system is unfair – that it takes people's money and uses it to pay for someone else's benefits. They argue that it would be better if people invested some or all of their own money for their own retirement. In this way, they contend, people would feel they had gotten what they paid for based on their own decisions about how to prepare for retirement. If they want to take more risks, they should be able to. If they want to be more cautious, they could do that too. Simply stated, proponents of a more individualized system argue that people should have more choices.

Proponents of the current system say that it serves social purposes as much as those of the individual – that it protects society, as much as the individual, against poverty. They argue that in the absence of Social Security, widespread destitution and income disparity would exist among the aged and disabled, the cost of which would have to be borne by society in some way – through higher welfare spending, higher governmental spending on social and health services, less tax revenue, and other adverse social effects. They do not dispute the claim that people should have investment choices, but contend that the current system should continue as a

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[2] The costs of the Social Security program, both its benefits and administrative expenses, are financed by a tax on wages and self-employment income. Commonly referred to as FICA and SECA taxes (because they are levied under the *Federal Insurance Contributions and Self-Employment Contributions Acts*), these taxes flow each day into thousands of depository accounts maintained by the government with financial institutions across the country. Along with many other forms of revenues, these Social Security taxes become part of the government's operating cash pool, or what is more commonly referred to as the U.S. Treasury. In effect, once these taxes are received, they become indistinguishable from other monies the government takes in. They are accounted for separately through the issuance of federal securities to the Social Security trust funds — which basically involves a series of bookkeeping entries by the Treasury Department — but the trust funds themselves do not hold money. They are simply accounts. Similarly, benefits are not paid from the trust funds, but from the treasury. As the checks are paid, securities of an equivalent value are "written off" the trust funds.

[3] The Secretary of the Treasury basically follows a passive investment policy under which the management of the federal securities acquired and held by the trust funds is dictated by an administrative process that does not involve the Secretary in buying and selling securities in the financial markets. The process is largely an "in-house" operation. The Secretary does have authority to buy and sell federal securities in the open markets on behalf of the trust funds, but since the program's inception has rarely done so. The implied policy is that such action would be taken only to stabilize the markets. The Secretary also has authority to buy and sell other securities for the trust funds that are guaranteed "as to both principal and interest." In the past, the trust funds have held such securities in the form of obligations of the Federal National Mortgage Association, Government National Mortgage Association, and Federal Home Loan Bank Board.

"bedrock" of protection against the "vicissitudes of life."[4] They argue that people can still make choices, but through their personal savings and private pensions, not through Social Security, which should provide a foundation of economic security.

Elements of both camps say investments in the nation's financial markets can help make the system more secure. Although the system's income currently exceeds its outgo, Social Security's current board of trustees projects that over the next 75 years the system's expenditures will exceed its income by 14% on average and by 2037 its trust funds will be depleted.[5] At that point its ongoing receipts would be sufficient to cover only 72% of its benefit commitments. By the end of the 75-year period, its expenditures would exceed its income by nearly 46%. Proponents of current system who support collective investment – i.e., who support investing a portion of the Social Security trust funds in the markets – contend that the higher yield to the funds from doing so could eliminate some or all of this problem without modifying the basic structure of "assured" support. Proponents of individualized investment distrust the government to invest without intruding into the investment process and private enterprise and would prefer that individuals grow accounts on their own that would provide a supplement to Social Security, perhaps allowing future Social Security benefits to be constrained enough to eventually balance the system's income and outgo.[6]

While shoring up the system is the catalyst for discussion, much of the debate emanates from a philosophical conflict about how much the government needs to be involved in securing workers' retirement incomes. In the 1930s, when Social Security was established, the condition of society was much different from circumstances

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[4] In signing the original Social Security legislation, the Social Security Act of 1935 (P.L. 271–74th Congress) on August 14, 1935, President Franklin Roosevelt described the concept in this way: "*We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age*."

[5] The Social Security Board of Trustees, comprised of three members of the President's Cabinet, the Commissioner of Social Security, and two members representing the public at large, annually projects the long-range financial condition of the Social Security system. Traditionally, the Board uses a valuation period extending 75 years into the future. Although the measure of solvency was refined in 1991 to encompass shorter and more recent periods of valuation, generally long-range solvency — or what is technically referred to as "close actuarial balance" — is assumed to exist if the system's average income over the 75-year period as a whole is projected to be within 95% of its average costs. See *2000 Annual Report of the Board of Trustees of the Old Age, Survivors, and Disability Insurance Trust Funds*, Government Printing Office, Washington, D.C., March 30, 2000.

[6] Not all proponents of the current system support using the financial markets to help shore up the system. Vice President Al Gore, for instance, supports using current federal budget surpluses to reduce outstanding government debt and crediting the Social Security trust funds with a portion of the interest savings – the crediting would be only in the form of federal securities as is the practice today. Although not yet proposing or endorsing a specific reform plan, Presidential candidate George W. Bush has stated that he favors allowing people to use some of their Social Security taxes to create individual accounts that could be invested in the financial markets.

today. The country was just emerging from a depression, unemployment was high, and poverty was widespread. In the aggregate, the nation is much wealthier today. In 1935, the unemployment rate stood at 20%, down from 25% in 1933. For much of 1999, it was under 4.5%. Disposable per capita income (adjusted for inflation) is more than four times higher now. Average earnings, similarly adjusted, are 2.3 times the 1937 level. By some estimates, in the early 1930s more than half of the elderly were in a state of economic dependency. In 1998, the overall poverty rate for people age 65 and older was 10.5% – lower than the rate for the total U.S. population. While much of the drop can be attributed to Social Security, 63% of the elderly had income in 1996 from personal assets, and 41%, from other pensions. Almost half of employed workers over age 15 today have employer-provided pension coverage; 62% of full-time, year-round workers age 25-54 have it. Some 41% of households own stock; 43% have IRAs, Keogh plans, or other tax-favored savings arrangements; 31% have life insurance; 23% own savings bonds; and 65% own their own homes with an even a higher percentage, between 70% and 80%, for the elderly. While these figures show gaps as well as economic advancement, they raise the question of whether the program established in the 1930s is the program needed for the 21st century, and, specifically, whether the societal "floor" that Social Security affords today's retirees needs to be as large and extensive in the future as was assumed necessary in the past.

Those who advocate for the current system argue that while economic conditions have improved, Social Security still fulfills much of its original purpose. When the system was created, its role was generally viewed as earnings replacement, not wealth accumulation. It was a response to the dire economic conditions of the early 1930s, and its proponents saw it as an eventual means of keeping a large segment of the workforce from slipping into poverty in old age. It was to provide a lasting "floor of protection," a means of affording the nation's workers with at least a minimal income during retirement without having to rely on welfare.[7] While, on the whole, the elderly are much better off today — in many respects, they have achieved economic well-being equal to or greater than the non-elderly — Social Security remains the dominant source of their retirement income. All other things held constant, Social Security lifted some 41% of the elderly out of poverty in 1996. Certainly for some, it simply adds to their wealth, augmenting an already ample income from other sources.

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[7] Reinhart A. Hohaus, an actuary with the Metropolitan Life Insurance Company and a member of two of the earliest Social Security Advisory Councils wrote in 1938 that: "*Social insurance ... aims primarily at providing society with some protection against one or more major hazards which are sufficiently widespread throughout the population and far-reaching in effect to become 'social' in scope and complexion. Usually these risks are not many in number. Yet, if not guarded against by some organized means, they produce large dependency problems that take their toll in terms not only of financial but of human values as well. Directed against a dependency problem, social insurance is generally compulsory – not voluntary – giving the individual for whom it is intended no choice as to membership. Nor can he as a rule select the kind and amount of protection or the price to be paid for all ... Indeed, social insurance views society as a whole and deals with the individual only as so far as he constitutes one small element of that whole. Consistent with this philosophy, its first objective in the matter of benefits should, therefore, be that those covered by it will, so far as possible, be assured of that minimum income which in most cases will prevent their becoming a charge of society ...*" (From Reinhart A. Hohaus, Equity, Adequacy and Related Factors in Old-Age Security. *The Record*, v. 37, American Institute of Actuaries, 1938).

However, the elderly are economically diverse. While only 4% of aged married couples had incomes below the poverty line in 1996, the figure for single men was 13%, and for single women, 20%. To the extent that Census Bureau surveys accurately reflect the elderly's well-being, Social Security accounted for 40% of the aggregate income of the population 65 and older. As such, it was their largest single source of income, with earnings from work, pensions, and asset income running a distant second, third, and fourth. For 66%, Social Security represented more than half of their income; for one-third of Social Security recipients, it represented 90% of their income; and for 18%, it represented 100%.

Calling it the nation's most successful social program, advocates of the current system seek to preserve its so-called *safety net* features and want its benefit provisions held constant to the maximum extent possible. They contend that to adopt a more individualized system, where how well one invests becomes critical to a worker's eventual retirement well being, would be too big a risk for too many of the most economically vulnerable in society. They see the current program as filling a necessary role for government arguing that it would be too difficult for too many to successfully navigate personal investments into an adequate retirement income.

Others, however, contend that society has changed; that its large "middle class" is much more capable today than in the 1930s of participating in a retirement investment system that does not rely on the government and that doesn't have at its roots a mandated transfer of income from workers to the aged and disabled. They argue that Social Security perpetuates itself as the dominant source of retirement income because people have become too dependent on it. They argue that employers, workers, and the nation's infrastructure of financial and investment institutions have evolved to the point where provision of a retirement safety net no longer needs to be as large a governmental function as it is today. They argue that given adequate incentives and governmental encouragement, perhaps even a mandate, people would be able to use the same Social Security tax dollars to save effectively for retirement on their own, possibly achieving greater returns and economic well-being than afforded by a politically-driven, governmental system.

The Case for Collective Investment

The investment process used by the current Social Security system is a collective one, meaning that it is for the benefit of Social Security recipients overall, not any one recipient. Social Security taxes go into the U.S. treasury and two Social Security trust funds are credited with federal securities.[8] There is no segmenting of these trust

[8] The Social Security tax rate is divided into three components under the law. One is for the Old Age and Survivors (OASI) part of the Social Security system; the second is for the Disability Insurance (DI) part; and the third is for the Hospital Insurance (HI) part of the Medicare program. The combined rate of tax for the three parts, paid by employees and employers, is 15.3% – 10.6 percentage points are credited to the OASI trust fund, 1.8 percentage points are credited to the DI trust fund; and 2.9 percentage points are credited to the HI trust fund (employees and employers each pay half of these rates on the earnings of the employee). In 2000, the OASI and DI portions are levied on earnings up to $76,200 (indexed (continued...)

funds into separate accounts for each taxpayer, and no person's Social Security record is credited or in any other way affected by the payment of these taxes. As with income taxes and other levies the government takes in, Social Security tax dollars are commingled in the treasury for general use, not for any one individual. An individual's Social Security record reflects only the earnings and wages on which his or her taxes were levied.[9] The benefits a recipient receives are not based on the taxes he or she paid as they would be in an IRA or 401(k)-type account, but on a record of those earnings averaged over much of the person's working years. A formula is applied to that average and a benefit is then derived. That benefit is paid from the treasury and the balance of the Social Security trust funds is reduced accordingly. In most months, the aggregate benefit outgo to all recipients is relatively close to the aggregate income received from all taxpayers.[10]

Since the money is commingled, any excess Social Security cash the government receives is used for any of the government's many other functions. The trust funds are then given a higher level of federal securities to reflect the excess.[11] The securities represent the investments of the trust funds, which are limited by law to U.S. government or government-backed securities.[12] The range of investment options has been deliberately limited to federal securities since the inception of the program. And even with this constricted practice, the Treasury Department has rarely been a market player.[13] Instead of going into the markets to buy and sell federal securities, the

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[8] (...continued)
thereafter to wage growth). The HI portion is levied on all earnings. Approximately 67% of aggregate Social Security tax receipts are currently credited to the OASI fund; 11% are credited to the DI fund; and 22% are credited to the HI fund.

[9] A worker's Social Security record is credited with earnings derived from the annual submission to the government of W-2 information by employers and Schedule SE's from the self employed. This action occurs totally independently of FICA and SECA taxes being withheld and deposited in the treasury. The Social Security record does not, nor is there any need for benefit or eligibility purposes, reflect whether and how much tax a worker actually pays.

[10] In the year 2000, tax income credited to the system is estimated by the trustees at $501 billion; expenditures are estimated at $410 billion. In effect, 82% of the system's current income goes to meet current expenditures. Tax income is projected to fall below expenditures in 2015 and remain so indefinitely thereafter.

[11] It should be understood that the commingling of funds is no different than that practiced by any large financial institution. The treasury, in this case, operates as a cash management device. As in a bank, the depositor's money doesn't sit idle for the subsequent use of the depositor; it is put to work by the bank to make loans or to meet the other immediate cash needs of the bank. The depositor's account is credited, and when subsequently drawn upon, the bank makes good using whatever funds it has available from the cash it has on hand.

[12] Section 201(d) of the Social Security Act states that "*Such investments may be made only in interest-bearing obligations of the United States or in obligations guaranteed as to both principal and interest by the United States.*"

[13] Section 201(d) allows the Secretary to purchase "*interest-bearing obligations of the United States or obligations guaranteed as to both principal and interest by the United States, on*
(continued...)

Treasury Department issues and redeems special non-marketable securities directly to and from the trust funds (what is basically an internal bookkeeping practice), securities that bear an approximation of current market interest rates but whose principal does not fluctuate with changing market conditions.[14] As such, the investments of the trust funds merely mimic the market in federal securities – the purpose being not to interfere with the market nor to advantage or disadvantage the Social Security trust funds. As a practical matter, the trust funds represent an authority to spend, operating more or less like a large checking account for the recipient population as a whole – meaning that as long as there are federal securities posted to them, the Treasury Department has "legal authority" and is required by law to issue benefit checks to recipients.

Perhaps the most important distinction is that these trust fund investments do not enhance an individual's Social Security benefits. In fact, it is largely irrelevant to the individual what the trust fund investments earn since the investments are not earmarked for any single person. If the trust fund balances rise or fall more than expected, it does not affect the level of individual Social Security payments. It is only the individual's earnings history, the benefit formula, and the related benefit computation rules in the law that will affect the benefit amount. Except in a relatively abstract sense, the individual has no stake in the investment outcome of the system (obviously, there would be an effect if the system were unable to finance his or her benefits because of an inadequate income stream).

A number of proposals have emerged over the past few years calling for a more expansive investment policy. Among them is a plan proposed by President Clinton that calls for investing a portion of the trust funds in the financial markets. The belief is that an actively managed fund that took advantage of investment yields from stocks and corporate bonds would raise the income of the Social Security trust funds. This was part of the President's January 1999 plan to credit the funds with a portion of the projected federal budget surpluses, some $2.8 trillion worth over the next 15 years, and use a portion of this amount to buy stocks. It was similarly reflected in his latest plan (January of 2000) to credit the funds with the interest savings resulting from

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[13] (...continued)
original issue or at the market price, only where he determines that the purchase of such other obligations is in the public interest." The Treasury's long-held view is that it will obtain or issue marketable securities to the trust funds only if there is some reason of overriding national policy. As a matter of practice, the Secretary of the treasury has made such judgments sparingly and confined the acquisition of marketables for the trust funds to meet a perceived need to stabilize a particular market (not the general market in federal securities), most notably when prices were falling or in need of support.

[14] The value of these securities upon issuance – i.e., their "par" value – never changes. They are always recorded on the trust funds at their par value regardless of market conditions. As such, they are referred to as "special issues." The only thing that varies with market conditions is the interest rates assigned to them. Section 201(d) of the Act states that these bonds "*shall bear interest at a rate equal to the average market yield (computed by the managing trustee [the Secretary of the Treasury] on the basis of market quotations as of the end of the calendar month next preceding the date of such issue) on all marketable interest-bearing obligations of the United States then forming a part of the public debt which are not due or callable until after the expiration of 4 years from the end of such month ...*"

reduction of publicly-held federal debt engendered by his plan in the form of stocks.[15] The same theme can be found in one of three alternative proposals suggested in a 1994-1996 Social Security Advisory Council report (the so-called "maintain benefits" plan), which would have kept the system's benefit structure essentially intact by addressing most of the long-range problem with revenue increases (including an eventual rise in the payroll tax) and minor benefit cuts. To close the remaining gap, its proponents suggested that Congress consider authorizing investment of up to 40% of the Social Security trust funds in the stock market.[16] It also is reflected in H.R. 633 and H.R. 990 (Bartlett), H.R. 871 (Markey), H.R. 1043 (Nadler), and H.R. 2717 (DeFazio) in the 106th Congress, H.R. 336 (Solomon) in the 105th Congress, and to proposals of former Social Security commissioner, Robert Ball, and Brookings Institution economists, Henry Aaron and Robert Reischauer. Most call for creation of an independent or quasi-government board to manage the funds.

Proponents of collective investment argue that a more expansive trust fund investment policy could lessen the need for eventual tax increases and spending cuts to shore up the system.

Foremost among the arguments for a more expansive investment policy is that it could lessen the need for tax increases or benefit cuts to restore the Social Security system's long-range solvency. Based on historical average investment returns from stocks and corporate bonds, the Office of the Actuary of the Social Security Administration has consistently projected higher investment income from proposals that would invest a portion of the trust funds in the financial markets.[17] With Congress having tried twice

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[15] His January 1999 plan called for crediting the trust funds with $2.8 trillion worth of $4.9 trillion in projected federal budget surpluses over the next 15 years, and using 21% of such amounts to buy stocks ($.6 trillion). A revised plan he announced in June 1999 called for crediting the funds with the interest savings resulting from using Social Security surpluses to reduce publicly-held federal debt in the form of stocks until the stock portion of the overall trust fund holdings reached 15%. In a draft bill sent to Congress on October 26, 1999, subsequently introduced as H.R. 3165 (Gephardt), S. 1828 (Moynihan), and S. 1831 (Daschle), he dropped this part of the plan. The trust fund infusions were, instead, all to be in the same form as today's trust fund holdings, special non-marketable federal securities. However, in his Budget for FY2001, he proposed partial stock investment again, in the same form as his June 1999 plan. The new trust fund infusions would begin in FY2011. The Social Security Administration's actuaries estimated that they would range from $98.7 billion in FY2011 to $204.9 billion in 2016 and thereafter (with all such infusions ending in 2050), and that plan would extend the life of the system until 2054.

[16] See Social Security Administration. *Report of the 1994-1996 Advisory Council on Social Security*, Washington, January, 1997.

[17] In making long-range projections of the impact of various Social Security reform plans considered by the 1994-1996 Advisory Council, the Office of the Actuary relied on analysis of Joel M. Dickson of the Vanguard Group, Inc., which indicated that the real yield on stock

(continued...)

in the past 25 years to shore up the system with incremental tax increases and benefit constraints, the system's defenders are somewhat wary of doing so again. While acknowledging that some such actions may be necessary, from a political perspective, they consider none of them good. The message such changes send is that "you again need to pay more taxes for less benefits."[18] While the purpose – i.e., achieving solvency – may have a "positive" ring, another round of tax increases or spending cuts may be met with considerable doubt. Thus, to the extent the status quo can be maintained by a showing of higher potential investment income, options are avoided that could further sap public confidence.[19]

An underlying objective of this approach is to preserve the social nature of the system, which its defenders view as setting it apart from other means of retirement saving. From their perspective, it provides society with insurance against poverty. No other system, with the exception of welfare programs, attempts to assure the elderly as a group of a minimal retirement income. Unlike an employer pension plan, Social Security provides lower wage earners with a greater return on their Social Security taxes than it does for higher wage earners, and it pays extra benefits if a worker has dependents, including a dependent spouse. While benefits are indirectly related to the payment of "payroll" taxes, the "earned right" notion embedded in Social Security is not complete – not exact. Supporters feel, however, that the flavor it carries of being an "earned right" that is paid for has been a strong basis for the public's general support of the system. If taxes were to rise too much, they fear public support could be eroded by perceptions that people were not getting their moneys worth – that they are paying too much for too little return. Or conversely,

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[17] (...continued)
(i.e., discounting inflation) averaged approximately 7% annually from 1900 to 1995. This was greatly in excess of the projected 2.3% real annual yield assumed at that time for continued trust fund investment in government bonds. Since that time, in analysis of numerous alternative proposals, the actuaries have continued to project a higher yield on stocks than government bonds, albeit projecting a higher real return on bonds in the latest Social Security trustees' report, i.e., 3% annually, than in 1995. Although there also has been some recent debate about methodology and technical adjustments that might justify a projected return on stocks of say 6% or 6.5% annually (see for instance, November 1999 *Report of Technical Panel on Assumptions and Methods* of the Social Security Advisory Board), the actuaries continue to reflect a substantial "premium" for investments in stock over the current investment practices employed for the trust funds.

[18] Major reform packages enacted in 1977, during the Carter Administration (P.L. 95-216), and in 1983, during the Reagan Administration (P.L. 98-21), included various combinations of tax increases and spending constraints, including payroll tax hikes, partial income taxation of Social Security benefits, a revised benefit formula, phasing-in of higher ages for receipt for full benefits, a delay in cost-of-living adjustments, and mandatory coverage of employees of the federal government and non-profit organizations.

[19] It should be understood that just because the actuaries project a higher return from stocks and bonds, it does not necessarily mean that it is likely. The actuary's basically are looking at past performance of the markets for guidance in making projections. They are no more able to project future returns than any other forecasters in the securities business. As stated in all mutual fund prospectuses, past returns on investment are not a predictor of future performance, and the future is as uncertain for the actuaries as it is for any other forecaster of economic events.

if benefits were to fall significantly, the safety net features of the system would be diminished. They fear that the result of turning Social Security into an individualized system would be that the most economically vulnerable and unfortunate would be forced to rely on welfare-type programs, and that welfare programs do not fare well in the allocation of public resources. Ultimately, they fear a greater disparity of wealth among the aged and disabled – an economic phenomena that already is evolving in society as a whole as the very well off get richer while lower and middle income segments see little or only modest economic improvement. While Social Security may be an inefficient income-transfer program, they see it as a hedge against rising income disparities and as an effective means of keeping a major segment of the aged and disabled out of poverty without the trappings, denigration, and public distaste of welfare programs.

Arguing that if the markets can be used to enhance the wealth of individuals, collective investment proponents ask "why can't they be used to increase the return for the Social Security system?"

In a political sense, promoting an expansive investment policy takes advantage of an idea that the system's advocates would not otherwise be expected to pursue – i.e., they would not instinctively seek to make use of the financial markets. Calling for such has been a mantra of those seeking to individualize or "privatize" Social Security. Proponents of an individualized account system have argued for years for use of the investment potential of the markets to power a system that does not rely on taxes and the government. The system's defenders attempt to co-opt the issue by arguing that if the markets can be used to enhance the wealth of individuals, why can't they be used to increase the return for the Social Security system? In a sense, their approach is to share the advantages of markets with the group as a whole.

They recognize that the public has misgivings about having the government invest in private businesses and that policymakers have resisted such a practice, but they contend that an effective means can be established to insulate the trust funds (and therefore the nation's businesses) from political influence and manipulation. They advocate creation of a quasi-government investment board or entity to manage the funds, similar to that used for the Federal Employees Thrift Savings Plan, with perhaps the independence and stature of the Federal Reserve Board. To avoid preference being shown for one industry or company over another, they recommend the use of market index funds.[20] They contend that state and local governments have engaged in market investments on behalf of their pension systems for years without adversely affecting the returns those funds earn nor exercising undue influence on the businesses they invest in.

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[20] These are mutual funds or related financial instruments whose holdings represent the stock of companies who make up one or another of the stock market's composite indices, such as the S&P 500. These funds attempt to mirror the performance of the particular index involved.

Those pursuing market investment of the trust funds contend that doing so disperses risks inherent in an individualized account system.

Much of the appeal of individual accounts emanates from the dramatic gains seen over the past two decades in stock indices such as the Dow Jones Industrial average and the Standard and Poor's 500 (S&P 500). Moreover, the proliferation of 401(k) plans and other employment-based individual account arrangements has demonstrated the popularity and workability of an individualized retirement savings system. However, individual accounts do put the risk of adverse market performance on the individual, not the employer or the government. The Social Security system's defenders argue that the tendency to look at averages of past market performance and deduce that individuals can achieve those results indefinitely in the future oversimplifies the complexity of investing and minimizes the effects of individual responses to risk and expanded choices. Markets are volatile and do not always go up. Moreover, they don't have a predictable pattern and investors' timing may be off. Simply stated, when they enter and exit the markets is important. The Dow Jones Industrial average has risen 10-fold from 1983 to the present, but it began and ended the preceding15-year period at the same level. Individuals also may suffer from the choices they make (assuming individual stock choices were to be permissible under a reform arrangement). Even within a generally up-trending market, there are always sectors that do poorly. And studies of 401(k) behavior show that a large number of people who participate have invested far too conservatively, undercutting the potential of long-term compounding of market returns and tax deferrals.

If annuitization is mandated, the value of the account will be fixed at the point of retirement even if the account accumulation has been eroded by a temporary downturn in the market. Critics also contend that the potential market returns that individual account proponents cite ignore the potential costs of annuitization. Annuity providers assume the risk of under-estimating longevity and changes in interest rates. They, therefore, exact a price from annuity purchasers for assuming that risk as well as for the administrative and marketing expenses they incur. Critics contend that these costs can be large and significantly erode the "net" returns achievable through individual investment accounts.

In contrast to these approaches, proponents of collective investment point out that it not only shares the market's gains but disperses its adversities. By protecting the individual from volatility, Social Security takes an element of fear and uncertainty out of retirement. A Social Security portfolio of marketable securities might drop during an adverse period, but the amount of an individual's benefits would be unaffected. They contend that just like the gains, the losses would be absorbed by the system as a whole.

Proponents of collective investment contend that it has built in economies of scale not achievable under a system of individual accounts.

Proponents of collective investment also argue that it is likely to carry economies-of-scale not achievable in an individualized account system. In an individualized system, millions of investors could potentially make millions of trades daily, each with some form of transaction charge (i.e., broker commission). Under a collective approach, stocks and bonds would be purchased in large blocks, presumably at a lower per unit cost, by fund managers with more investment expertise than most individuals would be expected to have. In effect, in a system of collective investment, society would reap the benefits of the markets without much of the "transaction" costs that individuals would incur. Supporters of individual accounts counter that the use of a limited number of investment companies and investing only through market "index" funds could mitigate such costs, but supporters of collective investment contend that even these changes could not match the "institutional" savings inherent in a collective approach. Less transaction costs would result not only from buying and selling in large blocks, but from less trading and churning of the markets. Under an individualized system, each account holder would have a stake in the outcome and thus potentially would become a market player. As such, they would likely trigger considerably more turnover of assets than if an equivalent amount of funds were collectively invested. A manager, investing in a particular sector on behalf of the Social Security trust funds, might buy 10 stocks a month. Individuals wanting to do the same might collectively drive millions of "buy" orders and sell them sooner than experienced stock managers, who would be expected to be more deliberative and disciplined in their approach and longer term in perspective.

A collective approach also would avoid the creation of sales and marketing costs, as well as employee (investor) educational expenses. In effect, society would avoid a whole layer of business activity designed to attract and educate millions of individual investors. Supporters of collective investment view these as "dead" costs, as dollars that could be more effectively employed as investments if a single board or quasi-governmental entity were responsible rather than millions of account holders funneling money into the markets through numerous investment companies. In other countries, where individualized systems were adopted, marketing expenses intended to attract individual account holders to specific investment companies are alleged to have detracted heavily from the potential returns. Moreover, educating the workforce to become savvy investors would create an expensive societal overhead cost. Someone would have to pay – the employer, the investment company, and perhaps the government. If paid by the employer, less contributions would be made to the individual's account or some other aspect of employee compensation would be reduced (i.e., be less than it otherwise would be). If paid by the investment company, the return on investment would be eroded. If paid by the government, the tax burden would be higher. There would be no free lunch. People would have to become educated investors, and someone would have to pay for that education. Proponents of collective investment contend that these costs are not minor – that they would put a substantial drag on the "true" returns people would be able to achieve in an individualized system.

Those wanting to strengthen the current system through collective investment feel that it avoids the inherent complexities and anxieties of growing individual accounts.

An individualized system also would be expected to add a new dimension of complexity to people's lives. The simplest manifestation of this effect is in the increased record keeping it would dictate – for the employer, employee, account manager, and the investment company making the market transactions. Even in an era of advanced automation, more accounting also means more errors. At any stage of human involvement, a mistake can be made. Errors are time consuming and expensive to fix since corrections are not usually subject to automation. Social Security now has a relatively low error rate. Simply stated, an individualized system by definition requires more attention. Moreover, critics of an individualized system contend that attentiveness to the process does not assure better outcomes. Too much attention could lead to too much market churning. In an exaggerated sense, individualized accounts could turn the nation's workers into a "society of market players" with all the potential trappings of obsessive attention to the vagaries of market behavior. More choice also means more complexity in people's lives, with the likelihood of increased anxiety about and during retirement. In effect, there could be psychological costs for society as a whole. In addition, while it is likely that people generally would become better investors, they would be diverted to some undefined extent from other potentially more productive facets of their lives.

Some economists argue that a collective investment approach potentially avoids or lessens savings "leakages" that would arise under an individualized system.

Economists generally are agreed that to the extent the nation can save at a higher rate in the coming years, the potential demographic strains imposed by the baby boomers' retirement and the gradual aging of society could be more easily accommodated. Some express a cautious note about converting Social Security into an individualized system, pointing out that because a large number of people save today on their own, creation of a new savings system might cause them to reduce the savings they already do through other means. As people see their new accounts grow, they might ask themselves why they need to save as much elsewhere, such as in their 401(k)s or IRAs. To the extent they reduce those other savings, national savings are less. Simply stated, critics of individual accounts contend that they are likely to cause "leakages" in the nation's savings system. They argue that collectively investing a portion of the Social Security trust funds would have fewer such effects. Individuals would not see the accumulation of wealth through new individual accounts, and to the extent they do not see any obvious changes in their potential Social Security benefits, they would be less inclined to alter their other savings behavior. Hence, advocates of collectively investing a given sum of Social Security

dollars argue that doing so would have a greater positive economic impact on the whole than the same amount invested in individual accounts.

Others contend that collectively investing through Social Security potentially avoids pressures to make alternative use of monies intended for retirement.

Advocates of collective investment contend that individualized accounts might create other types of savings "leakages" as well – namely consumption of the accumulated sums before retirement. Social Security allows for the pre-retirement payment of benefits only for disability or death. The exclusivity of these non-retirement uses has held up for 60 years. Critics of individualized accounts contend that the assets that would build up in them – even if intended for retirement purposes – are likely to be eroded by demands to make them available for other non-retirement purposes. They believe that demands for early liquidation for a variety of life's needs would become too strong and eventually the political process would succumb. Other existing tax-deferred savings vehicles (401(k)s and the like) already allow for loans and lump-sum withdrawals to be made prior to retirement, even when sometimes subjected to considerable penalty. IRAs can now be drawn down to purchase a house, finance the cost of education, and cover extraordinary medical expenses.[21] Critics of individualized accounts argue that given the political pressures that are likely to emerge, the expectation that new personal savings accounts would be a viable replacement for Social Security retirement benefits may be illusory. They argue that Social Security offers much greater assurance that funds collectively invested in the markets will be preserved for retirement.

Defenders of the current system argue that it provides a more stable base of retirement income for workers to build upon than an individualized system would.

Defenders of the current system also argue that the beauty of Social Security is that it provides a stable base of retirement income for workers to build upon. They see it as a form of societal guarantee. While acknowledging that Social Security does not provide the degree of certainty of a contractually-prescribed benefit, they contend that the economic factors that influence its financial viability are much less volatile than the financial markets. People don't suffer abrupt changes in their Social Security benefits because interest rates change suddenly or the market rises or falls sharply. They argue that Social Security allows people to better plan for retirement because it provides a relatively predictable source of retirement income, i.e., at least in terms of the amount of pre-retirement earnings it will replace.

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[21] The new "Roth"-type IRAs also can be annuitized at any age prior to retirement once they've been held for 5 years.

Many proponents of individualized accounts contend that minimum guarantees, investment limitations, and strong regulatory oversight can be employed to effectively provide an equivalent amount of societal guarantees. Critics contend, however, that the more this is done, the less the market returns would be, and the more the new system would look like a reshuffled Social Security system; that it wouldn't be better, just different. They contend that the more proponents of an individualized system attempt to achieve social ends, the more illusory their goal becomes.

Some argue that collectively investing in the name of Social Security carries a potentially larger fiscal policy benefit.

Advocates of collective investment also see a fiscal policy benefit to their approach. Using some or all of annual Social Security surpluses for investment in the markets reduces the overall amount of budget surpluses available to federal policymakers for tax reductions or new spending programs. It has the same (or similar) positive effect on the economy as reducing the amount of outstanding federal debt, since money that would otherwise be used to pay off holders of government debt would be invested directly in the markets. Debt reduction has been a major theme of the current Administration and Congress. In theory, reducing the portion of the federal debt held by the public frees up money in the financial markets for savings and investment. When the holder of a government security is paid off, the perception is that most of the proceeds are reinvested in private securities or enterprises. This makes more capital available and dampens interest rates. Ultimately, this influx of new capital could lead to a larger economy in the future, one that might be better able to sustain the rise in projected government entitlement expenditures when the baby boomers retire.

Proponents of collective investment contend that it is a more effective approach to guaranteeing the use of budget surpluses for economic growth than trying to hold an elusive political consensus to reduce the government's outstanding debt.[22] While the current Administration and Congress appear committed to making debt reduction a priority use of budget surpluses, the politics of this issue could change. At some future point, it may be difficult for a later President or Congress to fend off calls for tax cuts or spending increases. A recession, for instance, might be a catalyst for tax cuts; infrastructure or environmental needs or national calamities may pose the same

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[22] A unified budget surplus represents a surplus of governmental tax receipts taking virtually all of the government's many functions together, including Social Security and other programs accounted for through federal trust funds. These surplus receipts don't sit idle. In the absence of legislative measures that would increase spending or reduce taxes, the excess money is automatically used to reduce the debt – it happens as the Treasury Department pays off holders of federal securities (public debt) when they mature and when it buys up outstanding federal securities in the open markets as part of its debt management responsibilities. The reader should note that the federal debt is comprised of two basic parts: debt held by the public and debt held by governmental accounts such as the Social Security trust funds. When policymakers discuss using budget surpluses to reduce the government's debt, they are talking about reducing the portion held by the public. This is the only portion that influences the financial markets.

for new spending. Social Security is sometimes referred to as the third rail of American politics – "touch it and you die." Thus, proponents of collective investment argue that if the law called for use of Social Security surpluses for investment in the markets, the public could be expected to raise a clamor if someone wanted to use them for some other purpose. The claim could be made that the budget surpluses involved are excess Social Security dollars and are needed to make Social Security investments. To use them in some other way would weaken the system. Thus, the specter of misusing Social Security funds would emerge, raising a formidable rhetorical obstacle against any attempt to use that portion of the budget surpluses for some other purpose.[23]

Some feel that investing part of the trust funds in the markets provides the current system with a protective financing cushion long range.

Proponents of this approach also see a secondary benefit in the long range. In addition to potentially increasing the rate of return on the system's current holdings, they perceive market investment of some of its assets as giving it a protective cushion – from the perspective of an investment manager, the system would gain the benefit of "diversification." Although debt reduction may be a priority of federal policymakers today, many uses have been proposed for newly emerging budget surpluses. In a fiscal policy sense, collectively investing some or all of the portion attributable to Social Security surpluses would provide a more secure store of assets for the system in the long run. It would be different from simply crediting the trust funds with more government securities and then attempting to use the cash for debt reduction. In the latter case, while the money would be credited to the Social Security system, the budget surpluses themselves could be used for something other than debt reduction, namely tax reductions or new spending. Once enacted, those alternative uses might be difficult to roll back. Under this scenario, the government would have created other long-run fiscal pressures (less revenue or more spending on other activities) and potentially higher interest costs from not having used the money for debt reduction. Thus, when the Social Security system needed to draw on its reserves of government securities to help meet its future benefit obligations, there would be other fiscal

[23] Under official budget scoring rules, the Congressional Budget Office (CBO) estimates there will be unified budget surplus of $176 billion in FY2000. Of that amount, $153 billion is attributable to Social Security. The remaining $23 billion is attributable to the rest of the government's activities. This latter figure, however, reflects the effect of making $67 billion in "intra-governmental" payments to the Social Security trust funds representing interest and other internal credits from the government to the trust funds. As internal payments, they create no real governmental outlays, but for accounting purposes they show up as receipts to the trust funds and outlays to the rest of the budget. If these internal payments are ignored, the portion of the estimated budget surplus due exclusively to excess Social Security tax receipts is only $86 billion. Using the former scoring approach, CBO estimates that $2.3 trillion of its projected $3.2 trillion in cumulative unified budget surpluses over the next 10 years would be attributable to Social Security. Using the latter scoring approach, $1 trillion would be attributable to Social Security. [Derived from CBO's *The Budget and Economic Outlook,* January 2000, and other unpublished CBO estimates].

pressures on the government from decisions made today to commit budget surpluses to things other than debt reduction. Proponents of investing a portion of the next 15 years of Social Security surpluses in the market argue that it has the dual benefit of (1) making less of the looming budget surpluses available for new spending and tax cuts, and (2) giving the trust funds non-governmental assets to liquidate (i.e., an alternative source of financing) when it no longer has enough incoming receipts to cover its benefit commitments.

The Case for Individualized Accounts

Proponents of creating a system of individualized accounts see the current Social Security system as a dinosaur – a relic of the depression era. While the system has had its detractors since its inception, today's proponents of an alternative non-governmental approach are benefitting from a sizeable degree of public discontent and apprehension about the current system's long-run viability as well as an unprecedented run up in the stock market over the past two decades.[24] They also have been buoyed by reforms undertaken by other nations, a number of which had social insurance programs that pre-date the U.S. system. These countries have not only acceded to changing public sentiment about how to prepare for old age but have looked to reform of their governmental systems as a tool of economic stimulus and advancement.[25] They contend that people will save for old age on their own provided the right savings incentives or mandates, the use of payroll deductions and direct deposit, strict governmental oversight of the investment institutions involved, and appropriate limitations on the pre-retirement draw down of assets. This, they contend, has been amply demonstrated by the proliferation and popularity of 401(k) and related tax-deferred, individually-based savings plans in the United States.

They argue that society no longer needs a "big government" tax and transfer system. They concede that 65 years ago the nation's employers and financial institutions may not have been capable of launching and maintaining a national retirement system with the reach that Social Security had at its inception. However, they contend that with the subsequent advancements in technology, the widespread automation of record keeping, the massive improvement in communications, and the growth and evolving sophistication of the nation's banking and investment

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[24] Representative of this sentiment, reflected in many opinion polls over the past couple of decades, is one conducted by Gallup in May 1999 for USA Today, where 64% of "currently working" respondents stated that they did not think the Social Security system would have the money available to pay their expected retirement benefits. A Gallup poll done in June 1999 found that 58% of the respondents felt the system needed major reforms or to be "totally overhauled." Only 13% said "it was fine the way it is."

[25] Among them are Great Britain and Chile, whose reforms set examples for a number of other countries around the world. A somewhat controversial but widely disseminated 1994 World Bank report brought considerable attention to a shifting international climate toward governmental pensions and promoted the notion that a privately managed mandatory savings system should be a fundamental component of evolving international strategies for providing citizens with old age security, particularly in the context of "*avoiding many of the growth inhibiting problems associated with a dominant public pillar*" (see *Averting the Old Age Crisis*, The World Bank, Oxford University Press, 1994).

institutions, the framework for an individualized non-governmental system has become possible.

They stress that the issue they are raising is not about whether people need to save for retirement, death, or disability – they accept the necessity of having a national mandate and structure to do so – but more about *how*. Even those who propose a voluntary personal account system argue that it would be voluntary only in the sense of substituting for a person's Social Security participation – not whether the person should be able to opt out of both.

They view the anti-poverty role the government now plays as excessive. While agreeing that there is still very much a need for a government-run safety net program, they consider the dimensions of the current system too large. They contend that there is no need to transfer $500 billion annually of workers' incomes to the elderly to deal with an aged poverty rate that is currently under 11%, a rate as low or lower than that of the other age group of the population – and that the cost of alternative government run anti-poverty efforts could be considerably less.[26] While it is alleged that Social Security keeps 41% of the elderly out of poverty, they argue that the same or greater percentage could be kept out of poverty through a mandatory, employment-based, non-governmental system. They argue that the current system crowds out other means of retirement savings in two ways: by imposing too large a tax burden and by creating too much reliance on governmental income during retirement. They contend that an individualized system is the only way to truly advance-fund future retirement claims, not only making them more secure than under a governmental tax and transfer system but augmenting future economic growth with a more politically resistant savings mechanism.

They don't refute the idea that people like Social Security today, but contend that its acceptability does not emanate from it being an inherently better system. They contend that it's hard for people to question the worthiness of something that has evolved into being such a substantial part of current retirees' well being. They view the statistics of how many people depend on Social Security as the problem, not a measure of its success, contending that average workers today put so much into the system, they haven't got enough left over to save in a more productive fashion. If people could put some or all of their Social Security taxes elsewhere, they argue that Social Security would be a far less important source of future retirement income – and that would happen by choice.

The wide-range of ideas that proponents of an individualized system are pursuing reflects an entirely new way of looking at alterations to Social Security. Unlike past attempts to shore up the system, it is not about changing the system's benefit rules or making modest changes in its revenues or other sources of financing. These traditional approaches are not central to the newer thinking of proponents of individualized accounts. They want to take the debate further, to what they describe as "looking outside the box." What the current Social Security system would look like when altered is secondary and almost irrelevant under some plans. What virtually

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[26] The poverty rate reported using census data for 1998 for persons age 65 and older was 10.5%. For persons of all ages it was 12.7%.

all of them have in common is that the current system would be smaller, and perhaps eventually phased out entirely.

It is only at that juncture, however, that there is commonality, for the ideas range from a massive, nearly immediate overhaul to a gradual transformation taking a half century or more to complete. No single idea best reflects what advocates desire. For some, participation in a new individualized system would be voluntary; for others it would be mandatory. Some would keep a large remnant of the current system, either as a matter of principle to keep some continuity of a government supported safety net or simply to reflect the eventual lack of resources that the current system is projected to face. Others see the current system being phased out completely – some would do it quickly; others contemplate a long transition. Some provide considerable freedom of investment choices, while others confine them to very regimented choices managed by a limited number of investment companies. Finally, some involve carving out resources for the new accounts from existing Social Security taxes while others would use additional wage withholding or, alternatively, general government resources, i.e., budget surpluses.

In its most modest form, the creation of an individualized account system would be done without altering Social Security. This approach, reflected in a number of recent bills would require that future budget surpluses be used to set up personal accounts with market investment options for people currently paying Social Security taxes. The expressed view is that Social Security will eventually have to be constrained, and the creation of these accounts could help fill the benefit gap in the future.[27]

At the other end of the spectrum are proposals that would rapidly transform Social Security into a new individualized system. H.R. 249 (Sanford) and H.R. 874 (Porter) of the 106th Congress would allow workers to divert 8 and 10 percentage points, respectively, of the current 10.6% OASI tax rate (i.e., the employee/employer combined rate) into new personal accounts. These are often referred to as "carve out" plans since the income for the new accounts would come from the existing Social Security tax base. An 8 percentage point diversion would represent a redirection of 75% of OASI taxes; a 10 percentage point diversion would represent a redirection of 94%. Under H.R. 249, workers who opt for the new system would receive Social Security benefits equivalent to what they would have received had they turned age 62 and retired in the year 2000 and a minimum annual annuity from their personal

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[27] They include S. 263 of the 106th Congress (Roth) and H.R. 3456 (Kasich) and S. 2369 (Roth) of the 105th Congress. Although not presented in the context that benefits would eventually need to be constrained, the President's January 1999 reform plan included a similar approach allocating a portion of the then projected budget surpluses to new personal accounts supplemented by a worker's own contributions and a government match. The new accounts were to be targeted toward low and moderate income workers. The Administration has since given mixed signals as to how the proposal was to be viewed. Although there was some initial expression that these accounts were to be viewed as part of a Social Security reform plan, and thereby as supplements to Social Security benefits, Administration officials subsequently stated that the proposed accounts were to be viewed as free standing savings instruments designed to fill gaps in the nation's private pension system. The context for presentation was changed, not the reality of their being supplements to Social Security.

accounts.[28] S. 1103 of the 106th Congress (Rod Grams) and H.R. 3683 (Sessions) of the 105th Congress would similarly allow workers to opt for a new system altogether. Like H.R. 874, S. 1103 would allow them to divert 10 percentage points of the OASI tax rate into new accounts. Workers age 30 and older would receive "recognition" bonds for past Social Security taxes.[29] H.R. 3683 would allow workers to divert 6.2% of pay — the employee share of the tax — into new accounts. Employers would continue to pay their share of the tax to the old system for 15 years, after which they would contribute to the worker's personal account. The worker's Social Security coverage would decline by 20% per year until all protections were forfeited in the 5th year.

Among more gradual approaches is one proposed by five of the 13-member 1994-1996 Social Security Advisory Council (the "personal security account" plan), which called for redesigning the system by gradually replacing its retirement benefits with flat-rate governmental benefits based on length of service and private personal savings accounts funded with 5 percentage points of the OASI tax rate. Another is found in H.R. 3206 (Nick Smith) of the 106th Congress, which would allow workers to put 2.5 percentage points of the OASI rate into new personal accounts for the next 25 years, 2.75 percentage points for the period from 2026 to 2038, and an amount thereafter based on the yearly excess of aggregate Social Security revenue over expenditures. At retirement, each participant's Social Security benefits would be reduced by the amount of a hypothetical annuity derived from their accounts.[30]

Examples of partial approaches include one proposed by two members of the 1994-1996 Advisory Council on Social Security (including the chairman of the Council, and referred to as the "individual account" plan), which would have required workers to contribute an extra 1.6% of their pay to new personal accounts to make up for Social Security benefit cuts the plan called for to restore the system's long-range solvency. Another "add on" type plan (i.e., funded with monies other than Social Security taxes) suggested by economists Martin Feldstein and Andrew Samwick would create personal accounts funded with federal budget surpluses

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[28] For those remaining in the old system, H.R. 249 would gradually raise the full benefit age to 70, alter the basic benefit formula to produce lower benefits, reduce annual COLAs and spousal benefits, and extend Social Security coverage to newly hired state and local government workers. Under H.R. 874, workers opting for the new system would receive Social Security benefits (through so-called "recognition" bonds) based on their employment record before they joined and a minimum annuity from their new personal accounts. For those remaining in the old system, the bill would gradually raise the full benefit age to 70 and alter the basic benefit formula to produce lower benefits.

[29] Those choosing the new system could opt back into the old one within 10 years upon repayment of the taxes and any recognition bonds received.

[30] The bill includes numerous other major constraints to the current Social Security system that would greatly reduce its expenditures and make room for even larger long-range diversions of the tax for personal accounts. According to estimates prepared by the Social Security actuaries, the cost of the existing system would drop to a level equal to 27% of its current size in 2074. Memorandum from Stephen C. Goss, Deputy Chief Actuary, SSA, "*Estimated Long-Range OASDI Financial Effect of Social Security Solvency Act of 1999" Proposed by Representative Nick Smith*, November 3, 1999.

allocated to workers at a rate equal to 2% of their pay. Withdrawals from the accounts would cause a partial reduction in the worker's eventual Social Security benefits; i.e., for every $1 withdrawn, $.75 in benefits would be forfeited. In this way, the build up of the accounts would lead to an eventual reduction in the existing system's cost while enhancing future retirees' income. A related approach suggested by Representatives Archer and Shaw calls for partial funding of Social Security with withdrawals from the accounts.[31] Upon entitlement to Social Security, an amount equal to a "life annuity" would be transferred monthly from each worker's account to the Social Security system, and the higher of current law Social Security benefits or the life annuity would be paid. The new accounts would be managed by a select number of investment companies through portfolios containing a 60/40% split of equities and corporate bonds.

A plan suggested by Senator Phil Gramm incorporates both "add on" and "carve out" features. It would allow workers to divert three percentage points of their Social Security tax rate into new personal accounts with the government guaranteeing a higher retirement income than would be payable from Social Security alone. The guarantee would apply when a retiree's Social Security benefits plus an annuity from the new accounts are less than 120% of current law Social Security benefits. An additional 2% of workers' pay also would be contributed to the new accounts by the government (from budget surpluses), and the annuities from such would be used entirely to offset the cost of a worker's eventual Social Security benefits.

Various other partial approaches, using straight "carve outs," are reflected in S. 588 (Bunning), H.R. 250 and H.R. 251 (Sanford), S. 21 (Moynihan/Kerrey), H.R. 1793 (Kolbe and Stenholm), and S. 1383 (Gregg and Breaux) – all of the 106th Congress. All include either voluntary or mandatory partial diversions of Social Security taxes into personal accounts as well as other constraints on Social Security benefits to reduce the system's long-range cost.[32]

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[31] Instead of the offset occurring with Social Security benefits, it would affect the annuities paid from the personal accounts. The account balances of deceased recipients would be used to finance Social Security benefits of any eligible survivors or would otherwise revert to the Social Security trust funds. The balances of workers who die before entitlement with no eligible survivors would become part of the worker's estate.

[32] S. 588 (Bunning) would allow workers initially to divert 2.5% of their OASDI taxes into new personal accounts with the diversion amount rising to up to 50% over 20 years. Retirees would be required to draw down at least 75% of their personal account accumulations in the form of an annuity or other monthly payment based on their life expectancy and to take a 50% reduction in their Social Security benefits. H.R. 250 and H.R. 251 (Sanford) would mandatorily divert one percentage point of the OASI tax rate into new personal accounts (for those under age 55 upon enactment) managed by the Treasury in the same manner as the federal workers' Thrift Savings Plan (with the same investment options) or by banking institutions. Future Social Security benefits would be scaled down to take account of the growth of the accounts. S. 21 (Moynihan/Kerrey) would put the current system on a pay-as-you-go basis by immediately reducing the tax rate by 1 percentage point each on workers and their employers, and then raising it later in tandem with the system's future cost. Workers would be given the option of using the initial tax cut to create new personal accounts. If they did, their employers would have to match their contributions. H.R. 1793 (Kolbe and

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Proponents of a more individualized system argue that personal accounts have the potential to outgrow the value of future Social Security benefits.

Perhaps the foremost argument made by proponents of individual accounts is that they have the potential to grow much larger retirement incomes for people than the current Social Security system. There isn't much debate about the market's averages outperforming Social Security in recent years. While as a social insurance system, the potential rates of return vary considerably for people of different incomes and marital status (the tilted benefit formula favors low-wage earners and the provision of a "dependent" spouse's benefits favors one-earner couples), estimates by SSA's actuaries in 1996 suggest that for people born the following year, with subsequent careers of average earnings, the real return on their Social Security contributions would be only 1% or so; for low-earning workers, it would be around 2%; and for high wage earners, it would be zero or negative (i.e., they would not get back the value of their contributions).[33] They acknowledge that left to their own devices, people don't achieve a rate of return equal to stock market averages – even experienced portfolio managers have a difficult time doing so and most don't – but they argue that with the emergence of index funds, limitations on switching, and mandated withdrawal, annuitization, and liquidation schedules, many of the protective features of Social Security can be replicated while still allowing people to achieve a larger retirement income from their private accounts than from Social Security. They contend that even if people earned only a long-bond rate of return on their assets – now projected to be 3% annually in real terms – most would outperform their projected Social Security return.[34]

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[32] (...continued)
Stenholm) would mandatorily divert 2 percentage points of the tax rate into new personal accounts (for those under age 55 upon enactment). S. 1383 (Gregg and Breaux) calls for a similar diversion, with some or all of the annuities from these accounts causing a reduction in the worker's eventual Social Security benefits.

[33] These figures represent approximate "unisex" returns for full career workers (the figures are slightly lower for men than women). A low-wage earner is assumed to be someone always earnings 45% of the average wage; a high-wage earner is assumed to be someone always earning at least the maximum level taxable for Social Security purposes. Those with shorter careers would have higher returns. They also would be higher for two-earner couples (because of the provision of potential survivor benefits) and for workers with dependent spouses (although the vast majority of future retirees will receive benefits in their own right, not as dependents). See *Report of the 1994-1996 Advisory Council on Social Security,* v. 1, appendix II, Washington, January 1997.

[34] Commentators often mistakenly describe the rate of return that the trust funds are expected to earn as the rate of return that workers can expect to receive on their Social Security contributions. They are different. The trust fund rate of return does not effect the computation of a worker's benefits. As previously explained, Social Security is not a defined contribution system where the value of one's benefits is based on the amount and growth of what one contributes. The real trust fund rate of return projected at the time that the above
(continued...)

Fundamentally, proponents of an individual account system feel it would correct what they see as Social Security's contradictory mix of insurance and social welfare goals — that its benefits are not based strictly on a person's contributions as a personal account would be, yet because it is not means-tested, many of its social benefits go to well-to-do recipients. Hence, they view it as wasteful as a welfare program, and a "poor performer" as a pension system.

Proponents of individualized accounts also contend that their approach would deal more effectively with the public's uncertainty about their retirement security than investing the Social Security trust funds in the markets.

Proponents of individualized accounts also contend that their approach would deal more effectively with the public's uncertainty about their retirement security than investing the Social Security trust funds in the markets or adopting a traditional set of Social Security fixes (raising revenue or constraining benefits). They contend that the public really gives off mixed messages about Social Security. While on the one hand, the public says Social Security should be protected and preserved, a significant segment says that it is skeptical of the system and doesn't trust its potential to meet its long-run promises. They contend that the people who are least distrustful of Social Security are those now receiving it; it is in their self interest to feel so. Nonetheless, opinion polls repeatedly suggest that there is considerable public skepticism at all ages, and that it is most pronounced among younger workers. The system's critics contend that younger people are not secure and don't feel good about the program. Many complain about having to pay more in Social Security taxes than income taxes, and in their view, the injustice is only compounded by expectations that they won't get their money's worth. Proponents of individualized accounts say that younger workers frequently see advantages in saving through 401(k)s and other deferred compensation arrangements. Although Social Security's defenders say it may be illusory to view one's 401(k) as more secure than Social Security, its critics contend that there is a tangible feeling of worth from direct ownership of one's individual savings account – a feeling not present under Social Security.[35] They argue that recognizing this is fundamental in addressing the public's apprehensions about retirement – and that creation of individual accounts better addresses a desire to have a greater feeling of control over one's economic destiny.

[34] (...continued)
worker rates-of-return estimates were done was 2.3%; in the latest trustees' report (March 2000), it is 3%.

[35] In the aforementioned May 1999 Gallup poll, some 60% of currently employed respondents reported that they had an employer sponsored pension plan. In contrast to their reported apprehension that the Social Security system would not be able to pay the benefits they expected, 73% said their pension plans would have the money to pay their pension benefits.

Some contend that building an individual account component into the current system could actually strengthen its image, even if the system's taxes were raised and benefits constrained to address its eventual insolvency. The long-run outlook is for a continuing decline of the rates of return the system will afford. Raising taxes or constraining expenditures to deal with its insolvency will only worsen those returns. By incorporating a new individual account feature into the system, one that takes advantage of the present period of surpluses, the shrinkage in the system's returns could be mitigated by the more favorable market returns earned by the new accounts, as well as giving worker's a periodic measure of increasing net worth. The perception is that growing retirement savings accounts could restore credibility in the entire system.[36]

Perhaps the foremost argument made for an individualized system over collective investment is that it avoids the issues of government intrusion in the nation's businesses.

Perhaps the foremost argument against collective investment is that it directly or indirectly makes the government a market investor, and given the sums of money involved, potentially a principal stockholder and thus owner of many of the nation's businesses. Since the program's inception this has been the fundamental impediment to market investment of Social Security funds – i.e., the fear of government intrusion into private enterprise.

The problem with government ownership of stocks is the potential for politics, rather than the workings of a competitive free market, to determine the course of much of the nation's business. It steps across fundamental boundaries between the roles of government and private enterprise. The fear is of the political manipulation – of pressure being imposed on businesses to behave in a manner that serves the best interest of a political leader, a political party, or ideological or vested interests other than those whose assets are at stake. In the context of Social Security, the concern is that political opportunity would take the place of serving the best interests of workers and future recipients. It probably would not be blatant; in fact, most proposals attempt to guard against such. However, critics are concerned that with the trust funds being a public enterprise, whose charter is granted by law, there are inherent pressures on policymakers that over time would blur any initial commitment to keep public and private policy interests separate. They argue, for instance, that there would be an inevitable clash between achieving maximum investment returns

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[36] An idea of this type was put forth by former Social Security Commissioner Robert M. Ball in May 1998. Long an ardent supporter of the current system, he proposed creation of a voluntary "add on" component (workers would be able to contribute 2% of their pay, over and above their Social Security taxes, toward an individual account) as part of a more extensive reform plan that also called for collective investment of the trust funds. Mr. Ball stated that in addition to having people receive annual statements of their potential Social Security benefits (i.e., the traditional type), they would be given statements of "the amounts accumulating in the individual's supplemental savings plan." He viewed the new accounts as "logical add ons to a refinanced and fully dependable Social Security system." [From unpublished plan description prepared by Mr. Ball]

and the holding of "socially acceptable" investments. With a private fund, the fund manager is required to put the best interest of the fund participants first. Whether companies sell politically incorrect products, i.e., potential carcinogens, or fall into public disfavor as polluters, alleged monopolists, international opportunists, or for having poor labor practices, are less relevant factors in addressing whether a pension plan should acquire their stock. When the pension plan is the Social Security trust funds, however, there is a clear "public" interest in the investments of the funds. Why, some might ask, should the trust funds own tobacco stocks, or that of companies who "export" manufacturing jobs, gouge consumers, or sell products that harm the environment? Even if a stock index were used, why, it might be asked, not exclude them from the index? Critics of collective investment contend that there is no end to where the line can be drawn between public and private interests. They claim that there are clear examples of such behavior among state and local government pension plans that have invested in the markets.[37] Generally, they argue that an individualized system is the only way to avoid most of the issues of government intrusion into private enterprise, particularly if investment discretion rests with the individual.

Those who are apprehensive about collective investment believe that no governmental investment process could truly insulate business from political influence.

Proponents of an individualized system feel strongly that no body created for the purpose of conducting collective investment can be truly insulated from political influence. Ultimately a federal law would dictate the creation of any investment board or governing body, and the law that made it can be changed. Whatever the process, appointments have to be made. They allege that how they are made and why they are made cannot really be shielded from partisan or other related political influences. They acknowledge that an investment body could be created with safeguards (bipartisan representation, rules mandating that the "best interests" of the covered workers be served, the use of index funds, guidelines for selection of investment companies, SEC oversight, etc.), but contend that any such body would be independent in name only. Over time, there would be erosion because there would not be enough individual self interest to truly guard against it. In most instances, individuals would not see nor could they be shown direct harm from any alleged political decision – their benefits would not be impacted per se. Proponents of individualized accounts contend that concern about such a decision would not be nearly as large as if an investment body were directly responsible for one's personal wealth and well being.

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[37] For a discussion of these issues among state and local government plans and a sampling of examples, see CRS Report RL30218, *State and Local Pension Plans: Economically Targeted Investments and Social Responsibility Screening,* by Celinda Franco, Edward Rappaport, and James Storey, May 25, 1999.

Critics of an individualized system contend that whether policymakers want to create a new individualized system or opt for market investment of the trust funds, the action to do so could only occur through enactment of a law. They contend that just as Congress would have to create a board to undertake market investment of the trust funds, it would have to set up an entity of some sort to oversee an individualized account system. Thus, they argue that there really is no difference in the potential political influence that could be exerted under either approach. Proponents of individualized accounts counter, however, that there is a fundamental difference stemming from the fact that the money in the trust funds does not belong to any single individual, whereas the money in an individual account does. They argue that individuals would more readily react to a political decision affecting their personal accounts than one affecting a trust fund arrangement having no direct bearing on their benefits. Simply put, they contend that people are more apt to object to something that directly alters their own personal net worth. As evidence of this, they point out that no change has been made in the now 13-year old stock index fund (the "C" fund) of the Federal Employees Thrift Savings Plan, which is an individualized savings arrangement for federal workers similar to a private sector 401(k) plan.

Advocates of personal accounts contend that fear of the market is overblown and that ultimate pension risk is not confined to market volatility.

They also contend that fear of the market's volatility is overblown. They argue that people participating in 401(k)s and like arrangements have generally learned to accept the market's fluctuations – that they have learned to contend with the volatility or have opted for less risky investments, e.g., bonds. They argue that a large share of the public owns stock, has seen the market's occasional wild gyrations, and have learned not to panic at each turn. "Buy and hold," diversification, and "averaging in" are understood to be effective investment concepts, and mutual funds, portfolio management, and money markets are modern phenomena that operate today with considerable success in mitigating the "risks" of total loss.

They argue that defenders of Social Security use periodic stock market declines to attempt to instill "fear" of moving Social Security to an individualized system and to intensify the perception that Social Security as it stands is more secure. They argue that time is a proven remedy for market drops – once "fallen" does not mean that the equity values will never return; and after 30 or 40 years of building an account, a retiree will not suddenly need to spend all of his or her "depressed" assets when the downturn occurs. Most of the account accumulation will not be needed for current consumption and will have time to recover its value.

They further contend that Social Security has its own set of risks, foremost being the demographic risk associated with not having enough workers in the future to pay the taxes needed to make good on the promised benefits. They point out that Social Security's benefit package has been unilaterally changed in the past – the "full" benefit age has been raised from 65 to 67, the benefit formula has been altered to reduce its generosity, and COLAs have been delayed – and can be changed again by some future Congress. Thus, they argue, Social Security is subject to its own set of unique

demographic and political risks. Moreover, while the stock market may be more volatile than the economic factors that effect Social Security, over time Social Security's finances can be adversely effected by business stagnation and deteriorating economic trends. High inflation and unemployment triggered a rapid erosion of the system's trust fund balances in the mid 1970s and early 1980s forcing Congress to address both near and long-term problems with revenue increases and benefit constraints. Proponents of individualized accounts contend that no system, public or private, can optimally anticipate all the risks that may eventually alter its benefit streams. They argue that the biggest "risk" in the current debate is that fear and complacency about how to save Social Security will cause the nation to miss an opportunity to build larger and more secure retirement incomes for future retirees.

Some argue that individualized accounts offer a more secure way of earmarking budget surpluses for economic growth.

Proponents of individualized accounts also believe that it is a more effective approach to guaranteeing the use of the emerging budget surpluses for economic growth than using them to build larger Social Security trust funds. Regardless of whether budget surpluses were used to buy stock for the Social Security trust funds or used as a means to reduce publicly held debt, the ultimate disposition of the surpluses rests not with the taxpayers whose money creates them, but with federal policymakers. In other words, individuals would not have a direct say in how the money is used. Proponents of individualized accounts contend that there is a big difference in the political sustainability of earmarking money for a government trust fund (or for debt reduction) than earmarking it for individuals' personal accounts. If future federal policymakers decide that budget surpluses should be used to expand or create new programs or benefits, no one individual taxpayer can say that money is being taken from his or her account. The impact is not discernible on an individual level. However, if policymakers wanted to forego depositing money into an individual's personal account so that some other use could be made of it, there would be complaints by many of those affected. While proponents acknowledge that in theory the law can be changed in either case – i.e., to reduce the amounts earmarked for the Social Security trust funds or for individual accounts – they contend that altering the rules for personal accounts would be much harder. A decision by policymakers today to invest part of budget surpluses in stock for the Social Security system could be superceded by policymakers in 2002 or 2004 or at any later time who decide to spend the money instead. There might be heated rhetoric – i.e., Social Security was being "touched" – but there would be no direct economic impact that individuals could see. Changing the rules so that less of the budget surpluses would go to individual accounts, on the other hand, would be direct and highly visible. Each individual having an account could be shown how much less they would get. Hence, proponents of individualized accounts argue that these accounts are a more politically secure way of ensuring the use of budget surpluses for increasing capital and economic growth.

Proponents of individualized accounts contend that it is a "real fix" in contrast to collective market investment of the trust funds.

Proponents of an individualized system further argue that market investment of the trust funds is merely a palliative. In contrast to enacting tax increases or spending reductions that redefine the parameters and value of the system, collective investment would not really alter the system. Its effectiveness as a remedy to the system's financial woes relies directly on favorable market performance. In order to have any positive effect, the trust funds' new investments would have to out-perform government bonds – a return equal to that of bonds would be about the same as current law. Timing also is a factor – if the market does not produce a "premium" over bonds early enough in the 75-year projection period, there would not be the "extra" build up of reserves needed to sustain the system beyond its projected insolvency point (2037). Early capital growth in the system is necessary to get the benefit of compounding.

They further point out that if all that collective investment does is help bring the system into balance, there would be no room for a mis-estimate, and future Social Security benefits could be threatened. In effect, critics argue that if the market is risky for individuals in terms of rendering a reasonable retirement income from personal accounts, it is equally risky for the existing system as a whole in terms of achieving financial solvency. If the market doesn't perform but the impact is confined to individual accounts, the Social Security system is not threatened as it would be if it also relied on market performance. They charge that the only reason the system's proponents are advocating collective investment is to avoid having to take the "hard medicine" of raising taxes or constraining the system's future benefits.

Proponents of individualized accounts further argue that it would be better to enact the constraints needed to restore the current system's long-range solvency and buffer them with the creation of an individualized account system.

They argue that it would be better to enact the necessary constraints to the system and buffer them with the creation of an individualized account system. In this way, they believe that the system's solvency would be better assured, and even if the market did not perform well, individuals would still be building "something" on their own to buffer any future Social Security cuts. They contend that it would be easier to enact the constraints today and allow for their gradual implementation than to wait until insolvency is imminent. They speculate that if the projections upon which the benefit reductions were based proved to be pessimistic, there would be room to raise benefits in the future; politically, it would be easier to raise them then than to cut them once again.

In contrast to the creation of individualized accounts, some fear that building a larger trust fund could become an irresistible source of future spending.

The financing concept behind collective investment is that the building of larger trust funds than under current law will provide needed resources to draw on when the system's income no longer is sufficient to meet its expenditures. In theory, its purpose is to advance fund more of the resources that will be needed in the future. While not different in an economic sense from advance funding future retirement incomes through individual accounts, there is a large difference in who controls the disposition of the funds. Proponents of individual accounts argue that an individual controls the ultimate use of the money that is drawn from them. Third parties, i.e., federal policymakers, control the disposition of the Social Security trust funds. If an individual account were to grow larger than expected, the individual would decide what to do with the extra money – i.e., spend it or save it; the money is theirs. In contrast, greater-than-anticipated success with trust fund investments, in their view, would lead to a larger trust fund balance providing future politicians with welcome surpluses to spend. For instance, to the extent the economy did better than expected or demographic conditions improved, a larger trust fund might provide funds for a general expansion of the program. Even though an individual's taxes helped create the surplus, that person would have no direct say on how it was used. Proponents of an individualized system contend that it is very hard for lawmakers to resist the many complaints and inequities raised about Social Security, and point out that the urge to fix them is evident in the many bills routinely introduced to address a myriad of issues created by the system's current structure and benefit rules.

They contend that pay-as-you-go financing of the current system gives it a needed discipline. By its nature, pay-as-you-go requires careful scrutiny of possible new benefits. As such, it creates a needed firewall between politically popular ideas and good public policy. When they clash, policymakers can always argue that taxes would have to be raised or the system's financing would be threatened if every "great new idea" were enacted. In effect, it tests policymakers' resolve.

They further argue that a government doesn't need to advance fund a mandatory pension system when it can alter the system's benefits or financing arrangements unilaterally. This "right" of the federal government was long ago tested in the courts.[38] Recognizing this flexibility early on, the notion that the system would be financed on a pay-as-you-go basis was decided with passage of amendments in 1939 – the year before it began paying benefits – and in the years since, as long as its future income and outgo were estimated to be in reasonable balance, its trustees have

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[38] In the case of Fleming v. Nestor (363 U.S. 603, 1960), the Supreme Court took the position that a worker's interest in Social Security was not contractual and "*cannot be soundly analogized to that of a holder of an annuity, whose rights to benefits are bottomed on his contractual premium payments ... To engraft upon the ... program a concept of accrued property rights would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands ...*"

declared the system to be financially sound. Critics of collective investment accept the justification for a contingency reserve – to assure the Treasury Department does not have to return to Congress every year or frequently to obtain the right to pay benefits. They see it, however, only as reserve of "spending authority," not a reserve of real resources from which funds are actually drawn to pay benefits. Why invest a reserve in the markets that is needed only as a "contingent" authority to write checks? The money ultimately comes from the government's authority to tax under the Constitution. They contend that a reserve for more than contingencies is simply an "invitation" to spend for benefit increases.