RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

CREATION DATE/TIME: 4-SEP-1998 16:46:24.00

SUBJECT: Social Security speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])
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TEXT:
(See attached file: socsec2.wpd)

Here's the revised draft. Feel free to call me at home (301-320-0375) if
you want to talk about it over the weekend.

Doug

- socsec2.wpd=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D99]MAIL46316274M.226 to ASCII,
The following is a HEX DUMP:

Draft Speech
REVISED 9/4/98
[Including both the introductory material and the Social Security material from previous drafts.]

Economic Challenges for the 21st Century

...

The American economy is now enjoying its best performance in decades. Unemployment and inflation are at their lowest levels in a generation, and the elimination of the federal budget deficit has caused the net national saving rate to double since 1992. At the same time, the near-term outlook includes some clear risks, and I will touch on these in a moment. But I would like to focus my comments on three economic challenges for the 21st century--Social Security, climate change, and the design of international financial institutions.

Beginning with current conditions, the U.S. economy appears to have considerable forward momentum. As you know, growth of real GDP slowed sharply in the second quarter from its extraordinary first-quarter pace. Inventory accumulation shifted down, and net exports plummeted, with exports dropping 8 percent at an annual rate. Yet, domestic final demand remained quite strong: Consumer spending advanced sharply again, and investment in both business equipment and housing continued to move up at a double-digit rate.

One result of robust economic growth over the past several years has been a marked tightening of labor markets. The striking decline in the unemployment rate has boosted real wage gains and created new opportunities for many Americans. But it has also increased the risk that wage gains will outstrip productivity advances and lead to a pickup in inflation. A different, and perhaps more worrisome risk, is presented by economic developments overseas.

Serious economic problems in Japan and many East Asian countries have not been resolved as quickly as many observers had hoped, and the recent financial turmoil in Russia has increased the dangers for emerging market economies around the world. Portfolio shifts toward the safety and liquidity of U.S. assets have helped to reduce our interest rates and thereby to boost household and business spending. But the sharp decline in net exports in the first half of the year emphasizes that slumping foreign economies can hinder U.S. economic growth.

Instead of dwelling on these immediate concerns, however, I want to use most of my time to discuss longer-term challenges. Let me begin with Social Security reform. The President and Vice-President have participated in several of a series of Social Security fora scheduled for this year, in which Americans have had--and will have--the opportunity to explore alternative solutions to the problems facing Social Security. The President proposes to begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security so that it can continue providing financial support to retirees, survivors, and the low income disabled for many generations to come.

Before talking about the problems facing Social Security, I want to emphasize how important Social Security is to the lives of Americans and how successful it has been as a social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security benefits are the major source of income for 2/3 of those over age 65 and virtually the only source of income for 1/3 of the elderly. The system has enjoyed dramatic success in reducing poverty rates among older Americans. In addition, Social Security provides valuable survivors' and disability benefits to the 1 in 3 beneficiaries who are not retirees.

The central problem facing Social Security is the determination by the Social Security actuaries that the current balance in the trust fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP.

The President has enumerated five principles for Social Security reform. His first principle is to strengthen and protect Social Security for the 21st century, which means that we should consider only comprehensive reforms that eliminate the actuarial imbalance. The key factors contributing to the projected imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. In 1960, that ratio was 4.5 to 1; today it is 3.3 to 1, and in 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. The solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing these steps is greater national saving.

Thus, another of the President's principles for Social Security reform is to maintain fiscal discipline. National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; if they are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to highlight some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the traditional defined-benefit structure of Social Security or move in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the trust fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways. First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security trust fund. These riskier assets--equities in particular--have paid higher returns on average than government bonds, but they do involve risk. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the trust fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. These analysts note that swapping bonds for equities in Social Security involves a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this swap would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. Some supporters of these accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions.

One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits. Balancing flexibility against protection is a difficult problem. Another justification that is given for allowing individuals to choose portfolio allocations is to minimize government involvement in financial markets. I think it is an open question whether institutions could be designed that would allow the trust fund to purchase equities while ensuring that the government did not gain too much influence over the economy.

Critics of individual accounts raise a number of concerns beyond the ones I have already mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. It seems that progressivity would require, at the least, that contributions to these accounts be a larger share of payroll for lower-income workers. Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. These analysts note that many of these accounts would be quite small, especially when they were first established, and even a small cost per account could absorb a significant share of the annual investment return for many people. Restricting investment options or services would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

[What could be added? 1. Issues about raising the retirement age. 2. "The actuarial imbalance provides an impetus for rethinking the program in light of all the economic and social changes since the program was introduced." But then what do we say about this in detail? 3. More about the importance of maintaining "social insurance." 4. Annuitization of IAs.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: varvares@macroadvisers.com@INET@LNGTWY (varvares@macroadvisers.com@INET@LNGTWY [UNKNOWN])

CREATION DATE/TIME: 5-SEP-1998 16:07:30.00

SUBJECT: US Economic Outlook Now Available

TO: Janet L. Yellen@eop (Janet L. Yellen@eop [CEA])
READ:UNKNOWN

TEXT:
Greetings All:

The PDF version of the September 5 edition of the US Economic Outlook is posted on the Web site at:

http://www.macroadvisers.com/meo/meo.cgi

For those of you awaiting the hardcopy, it was deposited with the USPS today.

Regards

CV

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 5 Sep 1998 16:00:41 EDT
Received: from Storm.EOP.GOV by PMDF.EOP.GOV (PMDF V5.1-9 #29131)
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 by thor.inlink.com (8.9.1a/8.9.1) with SMTP id OAA28294; Sat,
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X-Sender: varvares@mail.inlink.com
X-Mailer: QUALCOMM Windows Eudora Light Version 3.0.2 (32)
================== END ATTACHMENT 1 ==================

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 18:41:23.00

SUBJECT: speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D73]MAIL40580315E.226 to ASCII,
The following is a HEX DUMP:

Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

[general comments: 1. Should we assign someone to fact check the whole speech? I found several places where your numbers didn't match numbers I had. 2. I rounded off some of the numbers you used, because I thought the barrage of precise facts was a little intense.]

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which are down $25-30 billion at an annual rate, according to our estimates, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system. That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which is finally sufficient to enable households to make up for ground they lost since the 1970s and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system--the so-called Halifax II agenda; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the Vice-President have participated in a number Social Security fora over the last five months and will participate in others scheduled for later this year. Their purpose is to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, from the Administration's point of view, the pledge to leave every penny of the surplus intact until reforms are enacted is ironclad. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses. [of course, we could have used that extra revenue to generate even bigger surpluses ...]

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. [I dropped the mention of the average benefit here, because that's only the average *retirement* benefit for *workers without spouses*, but the facts about importance of SS as an income source apply to all SS benefits, I think.] The system has enjoyed dramatic success in reducing poverty rates among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a pension plan: It is a family protection plan, and 1 in 3 beneficiaries are not retirees. [this is the standard fact, but it somewhat overstates the true point; some of these folks are survivors of retirees, and pension plans generally provide this sort of benefit] For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled before retirement. [how can this possibly be true?]

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits under current law; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2030, the Trust Fund is expected to be depleted, after which time, contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect. [Maybe we can get away with this one sentence; it is an important point, after all, and this structure raises it as a factual matter without tying it directly to policy choices.]

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open-minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

The President's second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in 1935, the life expectancy of a 65 year old American was about 12.5 years. Today, life expectancy for a 65 year old is 18.1 years and rising. At the same time, people are retiring earlier. In 1950, the average age for receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from 4.5 to 1 in 1960 to 3.3 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $100 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by a year or reduce the taxable payroll gap by 0.05. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to discuss some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of Social Security or to move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways.

First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget used either to augment the Trust Fund or to fund individual accounts could at least partially mitigate the transition problem, by bringing additional outside funds into the Social Security system. [this is not quite as elegant as your version, but I was worried that your version sounded like we were getting something for nothing]

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier asse ts than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns than government bonds over nearly all long periods of time in the United States over the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. If such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. [I thought my original version was a little clearer here, so I put some of it back.] If the total supplies of equities and bonds were unchanged, this exchange would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt whether the government has the will to renounce the use of growing annual surpluses in the Social Security system. [I took out "to cover larger deficits in the non-social security accounts" because those acocunts are moving toward surplus now too.] Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing some scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations is to minimize government involvement in financial markets. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities while ensuring that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Saving Plan involves far less money than Social Security does, and it is a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

Critics of individual accounts raise a number of concerns beyond the ones I have already mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. [Note that these two previous numbers are not directly comparable: the first is cost as a share of inflows, while the second (and the numbers that follow) are costs as a share of the amount invested. So we need to be careful about the wording.] But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts over time could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of 10 to 15 basis points, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios. [I shortened this paragraph a little because it seemed like disproportionate attention to this topic.]

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. [I used "minimizes" instead of "eliminates" because there could be adverse selection across types of annuities if alternative types are offered. Is this hair-splitting?] But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

[I changed the following paragraph a bit. It doesn't really seem much more dangerous to me, but we should think about it some more.] In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding jobs or with disability.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 19:02:18.00

SUBJECT: Re: speech

TO: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Many thanks for all the excellent revisions to the speech. I would feel better if we fact checked it tomorrow. I distinctly remember that the dubious-sounding fact about disability and how many 20 year olds face disability before retirement came from some notes that Ken Apfel gave me some time ago--notes he uses for many presentations. I used that fact in my Atlanta/Oglethorpe speech. Of course, that doesn't make it correct. So let's check it all out tomorrow. Again, thanks for all of the help.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 14:53:00.00

SUBJECT: Restoring Growth to Emerging Markets

TO: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Matthew R. McBrady (CN=Matthew R. McBrady/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
I have used Nouriel's ten point proposals (slightly revised) to flesh out the idea of a POTUS speech Monday on the theme of restoring growth. Any comments or suggestions? I will send this to Lael shortly, to see if there is any interest..

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 09:04:39.00

SUBJECT: REMINDER

TO: Alan S. Polasky (CN=Alan S. Polasky/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Quindi C. Franco (CN=Quindi C. Franco/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Joseph E. Aldy (CN=Joseph E. Aldy/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
I need to submit an estimate of the hours you worked on climate change.
Please give me your numbers by noon today.
Thanks.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Nora E. Gordon (CN=Nora E. Gordon/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 13:32:34.00

SUBJECT: HS speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Michele Jolin (CN=Michele Jolin/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Attached is the speech for Friday. Thanks for your editing comments, Michele -- I've added them all in. Late this afternoon I will be going to see the school and meet with the principal. She will have some questions from the students, which we can either incorporate into the speech or just expect to come during the Q and A. Please let me know if you have any additional editing in mind.
Also, please let me know what type of briefing you would like on the school beforehand. I think probably a ten minute chat would suffice, but if either of you would like copies of the many materials the school has sent me (their curriculum plan, newspaper stories on the principal and the school) or if you'd like a written summary of that, I'd be happy to put that together for you.
This will be the culminating event of their two week orientation and everyone involved is very excited for it, so it should be a lot of fun.

Nora

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D92]MAIL481570151.226 to ASCII,
The following is a HEX DUMP:

ADDRESS TO CESAR CHAVEZ PUBLIC POLICY CHARTER HIGH SCHOOL
INDIAN TREATY ROOM, FRIDAY SEPT. 11, 2:00 P.M.

Note: there will be about 60 ninth graders, which is the entire school for the year. Also attending will be the principal, Mrs. Irasema Salcido, who is the person I have talked to, and the three teachers.

Thank you very much. Good afternoon. I'd like to welcome your principal, Mrs. Salcido, your teachers, Ms. Fighera, Ms. Russo-Downey, and **fill in new social studies name, check on any board members in attendance**, your parents who have volunteered to come along today **get names**, and all of you, the entering class of Cesar Chavez Public Policy Charter High School. I haven't met you all yet, but I know that all of you have been working very hard to start your school, and I admire your dedication.

I. Introduction

It is especially fitting that you all should be here today, in the Old Executive Office Building, with the White House right out the window, for two main reasons. One is that the Clinton Administration is a big supporter of charter schools, and of students, parents, teachers, and administrators striving for the best schools they can have. Your school is a great example of this. Your goal of academic excellence for serving the public is commendable. The other reason you should be here today is to learn your way around, because I hope some of you will be returning here in the future for professional reasons. You are at the Cesar Chavez School to prepare for college and for careers in public policy. For many of you, I hope that will mean serving your country through government service, either in the federal government, like us at the Council of Economic Advisors and everyone at the White House and in the many federal agencies, or in DC government or other city or state governments, or on Capitol Hill in the legislative branch of government. It is crucial that hardworking, smart, motivated young people like yourselves keep our government going, and that you are involved in public policy as educated and politically active young people before you begin these professional careers.

What I would like to talk to you about today is how you can get here, or to another job in public policy. Most importantly, I would like to tell you about how critical it is that you go to college, and what can you do now to get to college. I chose to talk to you about this today for two reasons. The first is that as an economist, I know that education is very important to your future. I also chose this topic after seeing some of your comments in your school newsletter, the Chavez Grapevine. Many of you wrote that you hope to make this city a better place through education. Lazema Brown wrote that she would like to "encourage young people to stay in school to get their education," Kristle Harrington wants to "fix DC schools," and Sandtruis Lucas wrote that children should not be on the street, but "should want to become someone important." I am thrilled that you are thinking about these issues already, and I think you already know my main message: that education is very, very important. Now I would like to tell you exactly why it is so important, and how you can all achieve the high goals you have set for college.

II. The Importance of Education

A lot of economic research is about using data to see patterns. By data, I mean any information collected in a thorough way. One area in which economists have seen a very strong pattern is in the importance of college. A lot of the research about the importance of college uses data collected in the census, from the entire U.S. population every ten years. Census data shows us that now more than ever, people who have a college education have better jobs with higher earnings than people without a college education. And the earnings of those who have gone to college are growing faster than the earnings of those who have not.

This trend is true for the whole population, so good advice for *any* high school student who wants a better income in the future is to study hard and graduate from college. This advice is *especially* important for all of you, as young people who care about DC and the United States and want to play a significant part in making your community a better place. For careers in public policy and public service, a college degree is very important. Many jobs will be open to you if you have a college degree -- but would be closed if you do not.

Your school is set up to help you go to college. That already puts you ahead of the game. Take advantage of the resources at your school, the tutoring, mentoring, and SAT preparation. The path to college will not always be easy, but it is something that all of you should be able to do. With the right academic preparation, that your school is offering to you, and with information about how college can be possible for you financially, nothing can stand in your way.

III. Getting to College

So what can you do to make sure that college will happen for you? Well, serious academic preparation in high school is an important first step. Math classes are especially important.

Students who take rigorous mathematics and science courses are much more likely to go to college than those who do not. Taking classes like algebra, geometry, and chemistry increases the chances of attending college for everyone, and especially for financially disadvantaged students. For students in low income families, taking these classes *triples* the likelihood of going to college. And what matters with math is what classes you take, not where you take it. Students from public schools who had taken these rigorous math classes learned just as much math, as measured on a standardized test, as students who took those same classes at private schools.

Unfortunately, many students do not take these courses. They *are* challenging, but *you can rise to the challenge*. Don't be scared of math. With practice, math, just like everything else, gets easier. You are especially lucky to have lots of sources of extra help available to you at your school. Use them. Use them early, and use them often, because math classes build on each other. If you feel confused at the beginning, get help then. If you fall behind in math class at the beginning of high school, it is hard to advance to the kinds of classes that will help you for college. So make a commitment to math now. You won't be sorry.

Not only will math classes help you get into college and help you once you are in college, but having a good math background is also important for more and more jobs. Like college, math is important for everyone, but especially important for you. If you want to change public policy, you must understand statistics. Even if you do not end up using statistics in your own work, you want to be able to understand other people's statistics, so you know if you agree or disagree with their conclusions. Math will help you read the newspaper critically. You should decide for yourself what you think about different issues, rather than just adopting the view of the person writing a newspaper article or reporting a story on TV.

And if you want to be an economist, math is absolutely necessary. Economists use math when they are analyzing data, to discover trends like the importance of college, or what makes a country's economy grow, or what makes a company profitable. They also use math to make economic models -- basically, using math to express an idea in a simple and elegant form. Other public policy professionals need to understand math and economics also. Budget analysts at the Office of Management and Budget, one block up on 17th Street, use math all the time to figure out the budget for the whole federal government. People on Capitol Hill use math to identify and think about key political and economic problems. And public interest groups use statistics all the time to make their arguments more credible.

Once you have taken all the academic classes you need for college, your work is still not complete. As I'm sure you have heard, college is expensive. There is a wide range in how expensive it can be. State colleges cost less, and very elite colleges cost more. You should go to the college that is best for you. Colleges that cost more in total tuition also give more financial aid, so that you might end up paying the same amount at two schools with very different tuitions.

What is financial aid? Well, financial aid for college is usually composed of three elements: grants, which are money the college or government or some other organization gives you for college and you never have to pay back, loans, which are partially subsidized by the federal government, and work-study, which is when the college gives you a part-time job to help pay for tuition and other costs.

IV. Conclusion

Because of what we know about how college helps people get jobs with better wages, and jobs that help our country improve and our economy grow, President Clinton has worked very hard to make sure that when we start this new century, the first two years of college will be as universal as a high school education has been for the last fifty years. That's why we've provided a HOPE Scholarship, which is a $1500 tax credit to help pay the first two years of college tuition, and other tax credits for the junior and senior year of college. We have also simplified the student loan program and made interest tax deductible on student loans. There are also now more Pell Grants and more work-study jobs. AmeriCorps is a way to earn money for college by doing community service. These probably sound like a lot of details to you now, but all you need to remember is that there are many programs available to help you pay for college, and that your school will help you figure out these programs. The Department of Education also has lots of information on the Internet to help you see which resources are right for you.

Because all of us at the Council of Economic Advisers are so impressed with your school and the commitment all of you have made, we are pleased that next time we will visit you at your school. This school year, several of our economists will be coming to talk to you about different kinds of economic policies. You'll learn about environmental policy and global warming, about what's going on in international economies, like the Asian currency crises and current developments in the Russian economy, and about some topics in labor and social economics, like welfare reform. We are very excited to be a part of the first year of the Cesar Chavez Public Policy Charter High School.

So now you know some important things to do in the next four years to prepare for an exciting and satisfying career in public policy, or, if you change your mind, in many other fields as well. Take lots of challenging academic classes now. Take four years of math. Aim high for college, and look into lots of different resources for financial aid.

At times, these things will be difficult. You will be tired. Some of your friends won't be studying as hard as you are. Keep going. If you stick with it, you will really be proud of all you will learn. And all that you learn will not only help you for college, for jobs, and as an educated citizen, but it will enrich your life and make you better able to help others. All of the people you see in important positions in public policy and elsewhere have had times in school when something was hard and they didn't feel like doing it. What you need to do is think about how good you will feel once you have learned whatever that hard thing is. View learning as a challenge. Embrace the challenge. And always remember the motto of your school: si se puede *(phonetic:see say pway-day)*, it can be done.

Now I'd like to spend some time answering your questions. I hear that you've all prepared some questions already. I'd be happy to answer any questions you have about economics, what we do at the Council of Economic Advisers, the federal government, or the policy-making process. Please raise your hands, and when you ask your question stand up and tell me your name first.

20 minutes of Q and A.

Before you go, we have some gifts for you. We have ...

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Elise H. Golan (CN=Elise H. Golan/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 12:30:33.00

SUBJECT: county trigger requirement in the emergency ag assistance package

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Janet,
Sandy passed me a copy of your memorandum on the county trigger requirement in the emergency agriculture assistance package. Looks good - where does this stand? Anything I can do to help?

Elise

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 14:29:55.00

SUBJECT: Re: HS speech

TO: Nora E. Gordon (CN=Nora E. Gordon/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Nora: Many thanks for the terrific speech--it is just perfect for the occasion. I have one small editorial suggestion. Near the end, you say something about how it will be necessary to have the discipline to work hard even when other friends might not be studying as much. How about staying instead something along the lines of the kids will all need to support one another in achieving their goal--that they can help one another over rough spots and work together to insure that they all succeed. (George tells me that in the Lang experiment--the school in Harlem where so many students went on to college after Lang offered to pay their way--research suggests that group solidarity was a very important factor. These students may be subject to pressure from peers not at the school to conform to a less ambitious set of goals. The kids can form a strong peer group, however, supporting one another in the face of those pressures and helping one another succeed. That is the basic thought. Thanks again for a terrific speech. I am looking forward to giving it. We can confer on Friday and you can tell me more about the school and the people.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

CREATION DATE/TIME: 8-SEP-1998 18:42:21.00

SUBJECT: speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:
(See attached file: macroad4.wpd)
- macroad4.wpd=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D86]MAIL46980315F.226 to ASCII,
The following is a HEX DUMP:

Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

[general comments: 1. Should we assign someone to fact check the whole speech? I found several places where your numbers didn't match numbers I had. 2. I rounded off some of the numbers you used, because I thought the barrage of precise facts was a little intense.]

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which are down $25-30 billion at an annual rate, according to our estimates, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system. That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which is finally sufficient to enable households to make up for ground they lost since the 1970s and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system--the so-called Halifax II agenda; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the Vice-President have participated in a number Social Security fora over the last five months and will participate in others scheduled for later this year. Their purpose is to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, from the Administration's point of view, the pledge to leave every penny of the surplus intact until reforms are enacted is ironclad. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses. [of course, we could have used that extra revenue to generate even bigger surpluses ...]

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. [I dropped the mention of the average benefit here, because that's only the average *retirement* benefit for *workers without spouses*, but the facts about importance of SS as an income source apply to all SS benefits, I think.] The system has enjoyed dramatic success in reducing poverty rates among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a pension plan: It is a family protection plan, and 1 in 3 beneficiaries are not retirees. [this is the standard fact, but it somewhat overstates the true point; some of these folks are survivors of retirees, and pension plans generally provide this sort of benefit] For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled before retirement. [how can this possibly be true?]

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits under current law; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2030, the Trust Fund is expected to be depleted, after which time, contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect. [Maybe we can get away with this one sentence; it is an important point, after all, and this structure raises it as a factual matter without tying it directly to policy choices.]

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open-minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

The President's second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in 1935, the life expectancy of a 65 year old American was about 12.5 years. Today, life expectancy for a 65 year old is 18.1 years and rising. At the same time, people are retiring earlier. In 1950, the average age for receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from 4.5 to 1 in 1960 to 3.3 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $100 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by a year or reduce the taxable payroll gap by 0.05. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to discuss some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of Social Security or to move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways.

First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget used either to augment the Trust Fund or to fund individual accounts could at least partially mitigate the transition problem, by bringing additional outside funds into the Social Security system. [this is not quite as elegant as your version, but I was worried that your version sounded like we were getting something for nothing]

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier asse ts than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns than government bonds over nearly all long periods of time in the United States over the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. If such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. [I thought my original version was a little clearer here, so I put some of it back.] If the total supplies of equities and bonds were unchanged, this exchange would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt whether the government has the will to renounce the use of growing annual surpluses in the Social Security system. [I took out "to cover larger deficits in the non-social security accounts" because those acocunts are moving toward surplus now too.] Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing some scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations is to minimize government involvement in financial markets. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities while ensuring that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Saving Plan involves far less money than Social Security does, and it is a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

Critics of individual accounts raise a number of concerns beyond the ones I have already mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. [Note that these two previous numbers are not directly comparable: the first is cost as a share of inflows, while the second (and the numbers that follow) are costs as a share of the amount invested. So we need to be careful about the wording.] But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts over time could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of 10 to 15 basis points, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios. [I shortened this paragraph a little because it seemed like disproportionate attention to this topic.]

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. [I used "minimizes" instead of "eliminates" because there could be adverse selection across types of annuities if alternative types are offered. Is this hair-splitting?] But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

[I changed the following paragraph a bit. It doesn't really seem much more dangerous to me, but we should think about it some more.] In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding jobs or with disability.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 09:02:53.00

SUBJECT: Macroadvisers speech

TO: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Attached is a revised version of the Macroadvisers speech. After considerable agonizing, I decided to stick with Social Security as the single theme and therefore added to what you had written. I would very much appreciate it if you could go over the speech and edit it as you see fit--with respect to content and its correctness or lack thereof, political correctness and style. Thanks too for the material on the Working Group meeting. We can go over together around 3:45.=================== ATTACHMENT 1
===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D92]MAIL45134305W.226 to ASCII,
The following is a HEX DUMP:

Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or even next year but instead in decades and even centuries in the future. We have had the luxury to elevate the priority of these longer term issues because the assessment offered repeatedly by the President and other Administration officials, that "the fundamentals of the U.S. economy are extremely sound", remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped its effects. The Asian crisis has taken a toll on U.S. exports, which are down $25-30 billion at an annual rate, according to our estimates, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system. That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national savings which is double what it was six years ago, real wage growth which is finally sufficient to enable households to make up for ground they lost since the 1970s and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system--the so-called Halifax II agenda; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating options, and some of the difficult tradeoffs that must be faced in devising a solution.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the

Vice-President have participated in a number Social Security fora over the last five months and will participate in others scheduled for later this year. Their purpose is to afford Americans the opportunity to better understand the issues facing the Social Security system and to explore alternative solutions to the problems facing Social Security. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support to tackle reform. Certainly, from the Administration's point of view the pledge to leave every penny of the surplus intact until reforms are enacted is ironclad. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of proposed initiatives were paid for so that they would not deplete projected surpluses.

It should come as no surprise that Americans are eager to fix Social Security because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. These retirement benefits are indexed for inflation and provide a lifetime annuity--a package which would be difficult if not impossible to obtain in private markets. The average monthly retirement benefit of $765 per worker per month is the major source of income for 2/3 of those over 65 and the only source of income for 18 percent of those over 65. The system has enjoyed dramatic success in reducing poverty rates among retirees, helping to lower the elderly poverty rate from about 35% in 1959 to 10.8% in 1996. Even so, the poverty rate among single, divorced and widowed women over 65 still remains at 20%. Although pension and other retirement income is as important as Social Security for individuals in the highest income quartile, less than half of all individuals aged 65 and older received a private pension in 1994. Social Security is also more than just a pension plan. It is a family protection plan: 1 in 3 beneficiaries are not retirees. It provides survivors benefits for the average wage earner who dies and leaves a spouse and two children equivalent to a $322,000 life insurance policy: one in six 20 year olds will die before retirement age. Further, it provides disability protection: a 20 year old has about a 3 in 10 chance of becoming disabled before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to be fall short of anticipated benefits under current law; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so that the Trust Fund will begin to decline; and by 2030, it would be depleted, after which time, income would still be sufficient to pay about 75% of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report this 75-year actuarial balance measure understates the financial imbalance over the very long term because the actuaries projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect. This means that most solutions which insure 75-year balance now will still entail a reemergence of imbalance simply with the passage of time. One key decision must thus be how ambitious a reform should be and how to measure the success of reform.

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem and many ideas have been and will be put on the table to address the imbalance.

The President has emphasized that at this stage in the debate he remains open minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of a national debate. However, the President has set forth five key principles to use as we assess reform options, reflecting his judgements about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal to divert existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive approach because it reduces Social Security's revenues making the existing imbalance even larger than it is now. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

The President's second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in 1935, American life expectancy for a 65 year old was about 12.5 years. Today, life expectancy for a 65 year old is 17.5 and rising. At the same time, people are retiring earlier. The average age for receiving Social Security retirement benefits was 68 in 1950; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from 4.5 to 1 in 1960 to 3.3 to 1 today. In only 30 years time, it will be just 2 to 1 and falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover $100 billion of surplus invested in government bonds would be enough to extend the expiration date of the Trust Fund by a year or reduce the taxable payroll gap by 0.05. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to highlight some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of

Social Security or move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways. First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget used either to augment the Trust Fund or to fund individual accounts could, however, at least partially mitigate the transition problem.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns on average than government bonds over nearly all long periods of time in the U.S. over the past century. Between, for example, 1959 and 1996, the equity premium averaged 3.84%. There is no guarantee, however, the equity premium in the future will match its historical average. Moreover, equity investments do involve risk. For example, on three occasions during the past 70 years the S&P 500 index has declined over two years by more than 35 percent, while Japan's

Nikkei has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole if they simply involve swapping bonds for equities without raising national saving. If the total supplies of equities and bonds were unchanged, this swap would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt whether the government has the will to renounce the use of growing annual surpluses in the Social Security system to cover larger deficits in the non-social security accounts. Some also argue that for many Americans without such accounts, IAs could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could probably not be funded out of the surplus forever, so that a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing some scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations is to minimize the government involvement in financial markets which would occur if, alternatively, the Trust Fund were permitted to purchase equities. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as IAs at lower administrative cost without some of the key risks, allowing for sharing the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities while ensuring that the government did not gain too much influence over the economy. Depending on the fraction of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing rates of return? How would stock proxies be voted? The Federal Thrift Savings Plan provides an example where governance issues have been successfully managed by insulating investment managers from political calculations, narrowly defining their goals and permitting investment only in indexed funds. However, the funds in that plan are individual accounts managed by the government, rather than a government Trust Fund. We can benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan is expected to begin investing in private securities in early 1999. The Canadians plan to have investment decisions made by a 12 member Investment Board, charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries. The fund will be prohibited from investing more than 10 percent of the fund in any individual company and from owning more than 30 percent of the voting shares of any one firm; and the regulations call for all equity investment to be undertaken passively, via indexes.

Critics of individual accounts raise a number of concerns beyond the ones I have already mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to fund individual accounts through a fixed percentage of the payroll tax benefit high income workers most. In contrast, proposals that have been advanced to fund individual accounts through flat contributions using projected budget surpluses could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high pointing to the examples of Chile and the UK, where administrative costs lowered retirement income by 20% or more. At present, Social Security pays more than 99 cents in benefits for every dollar paid in. Administrative costs of running the system are extremely low. However, analysts note that many of individual accounts would be quite small, especially when they were first established, and even a small cost per account could absorb a significant share of the annual investment return for many people. Administrative costs could particularly lower the returns for low earners and part time workers. For example, an annual transaction cost of 100 basis points per year is estimated to reduce an individual's retirement income by about 20 percent. A Department of Labor study found that average expense ratios for actively managed retail large equity funds average about 150 bp per year; passive funds, in contrast, averaged about 60 bp per year. In contrast, the Federal Thrift Saving Plan, a centrally administered system of individual accounts with a small range of investment choices, incurs costs of about 10 bp for investments. However, a national government run system of individual accounts would be much larger in scale, covering about 180 million participants who work for 6.5 million employers. Those who advocate that the Trust Fund invest in equity note that the administrative expense would be minimal--no more than a few basis point. Restricting investment options or services would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

If individual accounts are introduced as part of the solution to Social Security, the question will arise whether to require annuitization so that retirees do not outlive their assets. Some IA proposals require annuitization. An advantage of permitting but not requiring annuitization is that retirees could pass IA balances as bequests to their heirs. However, if individuals are permitted but not required to annuitize, the private market may be afflicted by the problem of adverse selection, raising the price of annuities and reducing coverage. And experience suggests that transactions costs in the private market are also high.

In addition to proposals concerning individual accounts, uses of the surplus and investment policies of the Trust Fund, negotiations on social security reform may entail consideration of options involving changes in the retirement age. At the same time that people are living longer, they are also working less at age 65 and above and retiring earlier. This trends are evident in other industrialized countries as well. Reform plans have been proposed that would index the retirement age to life expectancies, phase in the currently scheduled increase in the retirement age to 67 more rapidly or raise the retirement age beyond 67. Examining proposals to change the retirement age should be part of the public debate. But in the interest of fairness, it will be necessary to look closely at the likely impact of reform in this area on the minority of Americans in physically demanding jobs or with disability.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

[What could be added? 1. Issues about raising the retirement age. 2. "The actuarial imbalance provides an impetus for rethinking the program in light of all the economic and social changes since the program was introduced." But then what do we say about this in detail? 3. More about the importance of maintaining "social insurance." 4. Annuitization of IAs.]

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard A. Shelanski (CN=Howard A. Shelanski/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 18:31:45.00

SUBJECT: Today's NW call.

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Janet:

This afternoon's call was short -- short enough that when I called in at 4:20 (I had a meeting that ran over without my realizing it) the call was over. I got a briefing from Dorothy Robyn who said the following information was conveyed on the call:

1. Bruce Lindsey and Secretary Slater are going to Minneapolis to survey the situation and discuss options with the parties. One option under consideration is binding mediation.

2. The above efforts aside, things are moving toward appointment of a PEB. The goal would be to appoint one in time to get air service running again by Monday. According to Bruce, this means appointing a PEB by Thursday.

3. Senator Daschle is introducing legislation to extend the cooling off period until Congress comes back in January. The rationale is that the PEB needs to report to Congress and cannot do so if it is in recess.

4. NW and one of the regional carriers are planning to file a motion to dismiss DOT's order that they resume service. The Gov't is readying to block the dismissal and enforce the order if other remedies (settlement, PEB) do not resolve matters.

That's about it. The next call is at 9:30 a.m. tomorrow (Wed.).

Howard.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Jeffrey A. Frankel (CN=Jeffrey A. Frankel/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 8-SEP-1998 14:55:45.00

SUBJECT: Restoring Growth to Emerging Markets

TO: Nouriel Roubini (CN=Nouriel Roubini/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Matthew R. McBrady (CN=Matthew R. McBrady/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
here it is
---------------------- Forwarded by Jeffrey A. Frankel/CEA/EOP on 09/08/98
02:53 PM ---------------------------

Jeffrey A. Frankel
09/08/98 02:53:13 PM
Record Type: Record

To: Janet L. Yellen/CEA/EOP, Nouriel Roubini/CEA/EOP
cc: Matthew R. McBrady/CEA/EOP
Subject: Restoring Growth to Emerging Markets

I have used Nouriel's ten point proposals (slightly revised) to flesh out the idea of a POTUS speech Monday on the theme of restoring growth. Any comments or suggestions? I will send this to Lael shortly, to see if there is any interest..

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D0]MAIL47385115N.226 to ASCII,
The following is a HEX DUMP:

Proposed theme for POTUS speech on global financial situation:

Need to Restore Growth in Emerging-Market Countries[1]

After the financial crisis that began in Thailand in July 1997, and quickly spread to Indonesia, Korea, and elsewhere, the initial response carried a heavy dose of economic austerity: sharp increases in interest rates in these countries, fiscal retrenchment, forced bankruptcies... Perhaps that was a necessary response at that stage, given the loss of investor confidence.... But a full year has gone by, and growth has not been restored... People are hurting... The prolonged crisis is jeopardizing the historic progress that was made in the 1980s and 1990s, when hundreds of millions of new recruits were brought into the global community of democracy and economies oriented around markets and international trade,... *The time has come to pass to a new more growth-oriented phase.*

Components of proposed plan:

1. A coordinated monetary expansion in the G-7 area. Such expansion is sensible for Europe (where the recovery is shaky), compelling for Japan (where we believe it would also have a positive effect on the region's financial situation), and necessary in the US to signal American leadership and concern about the global financial situation.

2. A rapid approval by Congress of the IMF refunding. Markets are currently under the impression that there is little money left for financial rescue of large emerging markets and that there is little political will to bail out other countries. Concerns about moral hazard effects of further bailouts may be an issue, but right now the market psychology is that, if Latin America collapses, we cannot and/or do not want to propose large rescue packages. The IMF refunding will help to change such negative market psychology.

3. An official IMF signal that substantial - but not exceptional - financial support will be given to large economies whose collapse may lead to systemic risks. Such support will be conditional on market reforms (to discriminate between Brazil that might deserve it and Russia who might not). IMF priorities have already shifted away from fiscal austerity in the three East Asian crisis countries over the last year.

4. A commitment by major financial institutions to roll over their lending to emerging markets and Latin America in particular. The private sector will have to do its share in preventing a global meltdown and should avoid the mistakes (failures to roll over loans) that led to the collapse of Korea and Indonesia. Some extra private contingent credit facilities (a la Argentina) with some

[1] The shift in emphasis toward growth is intended to be similar to that accomplished by Treasury Secretary Baker in the Baker Plan on 1985, three years into the 1982 international debt crisis.

IFI matching may also be helpful.
5. A new approach to corporate and bank restructuring in East Asia based on a more direct government involvement in the restructuring process, involving debt writedowns and restructuring of liabilities aimed at a rapid recovery of economic activity in the region.

6. A public commitment by emerging market leaders - especially in Latin America - to continue and accelerate market reforms and avoid debt suspensions, in exchange for financial support for structural adjustment.

8. A renewed commitment by Japan to accelerate banking reforms and add to the current fiscal stimulus with extra cuts in taxes (preferably a cutback of the consumption tax to 3%).

9. A US and G-7 commitment to provide Russia some financial support for long-run structural adjustment under the strong Russian commitment to continue market reforms agreed with the IMF in July, along with financial support for measures that enhance international security (a sort of Marshall Plan for Russia).

10. G-7 meetings (including a G-8 with Russia, and other G-7 meetings with main emerging markets leaders and unofficial consultations with large international financial institutions) to coordinate the package of measures discussed above.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-SEP-1998 16:30:05.00

SUBJECT: Beier memo on Northwest strike

TO: Dorothy Robyn (CN=Dorothy Robyn/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TO: Sally Katzen (CN=Sally Katzen/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

CC: Gene B. Sperling (CN=Gene B. Sperling/OU=OPD/O=EOP @ EOP [OPD])
READ:UNKNOWN

TEXT:
We agree with David Beier and OVP that a PEB should not be appointed at this time, and for substantially the same three reasons David offers. We are particularly concerned that the parties will have little incentive to reach an agreement during the cooling-off period without the financial pressure the strike places on both sides. Although we recognize that Northwest will not want to incur the costs of shutting down the airline a second time in the event the PEB is unsuccessful, there is still substantial risk of being in the same position several months from now that we are in today, during which time an unfortunate precedent for regular intervention will have been set. The parties appear to have further options they can explore privately before intervention is warranted.

I would be happy to discuss these issues with you in greater depth.

David W. Beier @ OVP
09/09/98 10:06:51 AM
Record Type: Record

To: Sally Katzen/OPD/EOP, Dorothy Robyn/OPD/EOP
cc:
Subject: Stock Options and NW

From our perspective we are not in favor of a PEB at this time. First, it would be inconsistent with the Administration's record of sharing the benefits of economic growth and our approach in 1993 in getting labor to make wage concessions to keep the airline alive. We should not be in a position of appointing a PEB at a time when management is reluctant to share in even future benefits in the form stock options. Second, there is little evidence that intervention will produce a positive or quick outcome. Finally, appointment of a PEB will do what we have all sougth to avoid; to wit, the use of PEB's in virtually all future airline labor disputes.

On the stock option question. It might be useful to have someoutreach to Treasury or the SEC --- informally --- to get some background on the accounting treatment the issuance of stock options would have on corporate earnings. My understanding is that this approach could actually have the net effect of increasing the share price of NW stock over time. This would appear to partially off set the potential dilution of the major shareholders. Clearly, Chechi et al. will have received robust legal and accounting advise. We should be in the position to at least know what they have likely been told.

Thanks

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

CREATION DATE/TIME: 9-SEP-1998 16:50:18.00

SUBJECT: final version of macro advisers' speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:
in case you want an electronic version for your records ...

(See attached file: macroad5.wpd)
- macroad5.wpd==================== ATTACHMENT 1 ====================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D21]MAIL464792255.226 to ASCII,
The following is a HEX DUMP:

Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which are down $25-30 billion at an annual rate, according to our estimates, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system.

That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which has recently been the highest in two decades, and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system--the so-called Halifax II agenda; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the

Vice-President have participated over the last five months in a number Social Security fora, whose purpose has been to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, the Administration remains committed to its pledge to leave every penny of the surplus intact until reforms are enacted. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses.

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a

pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect.

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open-minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

A second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in

1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $130 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by roughly a year or reduce the taxable payroll gap by about 0.1. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to

private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to discuss some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of Social Security or to move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways.

First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget--used either to augment the Trust Fund or to fund individual accounts--could at least partially mitigate the transition problem, by bringing additional funds into the Social Security system.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns than government bonds over nearly all long periods of time in the United States during the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years, the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. If

such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this exchange would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt that the government has the will to renounce the use of growing annual surpluses in the Social Security system. Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations

is to minimize government involvement in financial markets. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities but still ensure that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Savings Plan involves far less money than Social Security does, and it is essentially a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

Critics of individual accounts raise a number of concerns beyond the ones I have already

mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of about 10 basis points per year, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the normal retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding jobs or with disabilities.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])

CREATION DATE/TIME: 9-SEP-1998 18:15:35.00

SUBJECT: final draft of macro advisers speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

CC: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])
READ:UNKNOWN

TEXT:
(See attached file: macroad5.wpd)
- macroad5.wpd=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D55]MAIL41517325Z.226 to ASCII,
The following is a HEX DUMP:

Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

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That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which has recently been the highest in two decades, and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system, namely the design of a new financial architecture; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the

Vice-President have participated over the last five months in a number Social Security fora, whose purpose has been to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

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It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a

pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect.

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open-minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

A second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in

1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $130 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by roughly a year or reduce the taxable payroll gap by about 0.1. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to

private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to discuss some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of Social Security or to move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways.

First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget--used either to augment the Trust Fund or to fund individual accounts--could at least partially mitigate the transition problem, by bringing additional funds into the Social Security system.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns than government bonds over nearly all long periods of time in the United States during the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years, the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. If

such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this exchange would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt that the government has the will to renounce the use of growing annual surpluses in the Social Security system. Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations

is to minimize government involvement in financial markets. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities but still ensure that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Savings Plan involves far less money than Social Security does, and it is essentially a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

Critics of individual accounts raise a number of concerns beyond the ones I have already

mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of about 10 basis points per year, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the normal retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding jobs or with disabilities.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Howard A. Shelanski (CN=Howard A. Shelanski/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-SEP-1998 13:55:20.00

SUBJECT: Backing up OVP's position on a PEB

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

TEXT:
Janet:

I just forwarded you a message from David Beier (which Dorothy Robyn had in turn forwarded to me). His reasons for opposing a PEB are sound and Dorothy agrees that this would be a good time for us to weigh in. She suggests an e-mail from you to Gene before the 2:30 call today. Attached is my attempt at a draft message you might send.

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D27]MAIL499021257.226 to ASCII,
The following is a HEX DUMP:

Janet: Here's a possible message for Gene. I would cc Sally and Dorothy since they received David's e-mail.

Gene:

We agree with David Beier and OVP that a PEB should not be appointed at this time, and for substantially the same three reasons David offers. We are particularly concerned that the parties will have little incentive to reach an agreement during the cooling-off period without the financial pressure the strike places on both sides. We risk being in the same position several months from now that we are in today, during which time an unfortunate precedent for regular intervention will have been set. The parties appear to have further options they can explore privately before intervention is warranted.

I would be happy to discuss these issues with you in greater depth.

RECORD TYPE: PRESIDENTIAL (NOTES MAIL)

CREATOR: Douglas W. Elmendorf (CN=Douglas W. Elmendorf/OU=CEA/O=EOP [CEA])

CREATION DATE/TIME: 9-SEP-1998 16:49:13.00

SUBJECT: final version of macro advisers' speech

TO: Janet L. Yellen (CN=Janet L. Yellen/OU=CEA/O=EOP @ EOP [CEA])
READ:UNKNOWN

CC: Douglas_W._Elmendorf@oa.eop.gov (Douglas_W._Elmendorf@oa.eop.gov [UNKNOWN])
READ:UNKNOWN

TEXT:
in case you want an electronic version for your records ...

=================== ATTACHMENT 1 ===================
ATT CREATION TIME/DATE: 0 00:00:00.00

TEXT:
Unable to convert ARMS_EXT:[ATTACH.D96]MAIL46769225O.226 to ASCII,
The following is a HEX DUMP:

Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which are down $25-30 billion at an annual rate, according to our estimates, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system.

That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which has recently been the highest in two decades, and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system--the so-called Halifax II agenda; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the

Vice-President have participated over the last five months in a number Social Security fora, whose purpose has been to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, the Administration remains committed to its pledge to leave every penny of the surplus intact until reforms are enacted. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses.

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a

pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

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A second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in

1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

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Some opponents of individual accounts believe that the administrative costs of these accounts would be excessively high. The administrative cost of the current Social Security system is extremely low, representing less than one cent of every dollar of contributions. Investing part of the Trust Fund in equities would raise that cost only slightly, with the additional expenses probably amounting to less than a few basis points of each dollar invested. But the cost of directing the appropriate contributions to millions of individual accounts and managing the assets in those accounts could be much higher. In Chile and the UK, for example, the administrative costs of individual accounts may reduce retirement income by 20 percent or more. And in the United States, even passively managed index funds incur expenses that average around 60 basis points per year, according to a recent Department of Labor study. Moreover, analysts note that many proposals for individual accounts involve accounts that would be quite small, especially when they were first created, so that any fixed cost per account could absorb a significant share of the annual investment return for many people. The Federal Thrift Savings Plan incurs costs of about 10 basis points per year, but it allows for only a small range of investment choices, and all of its participants work for the same employer. Restricting investment options or services in individual accounts would reduce costs, but might disappoint people accustomed to better service for their private portfolios.

If individual accounts are introduced as part of the solution to Social Security's actuarial imbalance, the question will arise whether to require people to convert their account balances to annuities when they retire. One advantage of requiring annuitization is ensuring that individuals do not outlive their assets. Such a step may be especially important if withdrawals from individual accounts substitute for some part of traditional Social Security benefits, which automatically take the form of annuities. Requiring annuitization also minimizes the problem of adverse selection, which raises the price of private annuities today and reduces their use. But people may want to bequeathe some of their accumulated wealth, and requiring annuitization would restrict their ability to do so. Balancing these various objectives is another difficult problem.

In addition to proposals concerning individual accounts, uses of the budget surplus, and the investment policies of the Trust Fund, negotiations on Social Security reform may entail consideration of options regarding changes in the retirement age. As I mentioned earlier, and as you know, at the same time that people are living longer, they are retiring earlier. The increasing share of life spent in retirement--which is evident in other industrialized countries as well--is in part a natural reaction to higher income. But it may also be partly a reaction to public policies that unduly encourage retirement at specific ages. Social Security reform plans have been proposed that would phase in more rapidly the currently scheduled increase in the normal retirement age to 67, raise the retirement age beyond 67, or index the retirement age to life expectancy. Examining these proposals should be part of the public debate. But in the interest of fairness, we must look closely at the likely impact of any reform in this area on those Americans in physically demanding jobs or with disabilities.

I do not intend this discussion of difficult choices to imply that no solution can be found to the challenges posed by an aging society. Indeed, I am confident that a bipartisan effort to reform Social Security can succeed next year. But to achieve this goal, and to prepare the nation for the retirement of the baby boomers, we must continue to ask hard questions about alternative reform proposals. There is no magic bullet for Social Security reform, but careful analysis and thought can help guide us to the best decisions.

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Remarks of Janet L. Yellen

Chair, Council of Economic Advisers

to Macroeconomic Advisers' Washington Policy Symposium

September 10, 1998

It's a pleasure to join you today. A predecessor of mine on the Council of Economic Advisers warned me that on many days CEA members feel like those little steel balls in pinball machines--bouncing back and forth from one short deadline project to the next, forced to switch directions rapidly and with little warning. I understand what he meant. Crises requiring immediate attention are rarely in short supply.

Even so, a substantial portion of the Administration's economic agenda relates to longer term issues that will be critical to the performance of the U.S. and world economies not next week or next year but instead decades or even further in the future. We have had the luxury of elevating the priority of these longer term issues because the fundamentals of the U.S. economy are extremely sound. This assessment, offered repeatedly by the President and other Administration officials, remains accurate, in my view, in spite of our increasing vulnerability to repercussions from the current international financial crisis. Obviously, we have not escaped the effects of the Asian crisis. It has taken a toll on U.S. exports, which are down $25-30 billion at an annual rate, according to our estimates, as a direct result. It is causing losses at major financial institutions with emerging market exposure. And it is clearly contributing to volatility in our own financial markets. A widening or deepening of the crisis remains the single greatest threat to the continued expansion of the U.S. economy. The Administration is intensely focused on the need to restore growth to the world economy and stability to the world's financial system.

That said, the American economy has been and still is enjoying its best performance in decades, with unemployment and inflation at the lowest levels in a generation, a rate of national saving which is double what it was six years ago, real wage growth which has recently been the highest in two decades, and, importantly, a federal budget which is in surplus this year after three decades of deficits. As my colleague Joe Minarik undoubtedly emphasized this morning, if we maintain the fiscal discipline now in place, budget surpluses over the next decade are projected to exceed $1.5 trillion under both CBO and OMB (MSR) assumptions. It is in good economic times like these, that we have the luxury and the resources to anticipate problems ahead and prepare for them. Moreover, the cost of addressing longer term problems is usually lower when one has the foresight and discipline to act early than if one procrastinates.

Three of the central issues on our longer term economic agenda are the development of policies to reduce the risk of future crises in the international financial system, namely the design of a new financial architecture; measures to address the consequences of global climate change; and Social Security reform. Seeing that your agenda for this conference includes discussion of the first two of these topics, I thought I might most usefully focus on the third--Social Security reform--in my remarks today. My objective is to describe the problem we face, the President's principles for evaluating reform options, and some of the difficult tradeoffs that must be faced in devising a reform.

In his State of the Union address, the President proposed to "Save Social Security First" by reserving every penny of the surplus until we have agreed on a plan to secure the financial viability of Social Security. To accomplish this task, the President proposed a process of public education and debate followed by the forging of a bipartisan agreement. He and the

Vice-President have participated over the last five months in a number Social Security fora, whose purpose has been to afford Americans the opportunity to better understand the problems facing the Social Security system and to explore alternative solutions to these problems. This process of public discussion will culminate with a White House conference in December. The plan is to then begin bipartisan negotiations with Congressional leaders in January 1999 to devise a comprehensive plan to strengthen Social Security.

I think it is fair to say that the President's proposal to Save Social Security First has been enormously popular--so much so that there exists strong bipartisan support for tackling reform. Certainly, the Administration remains committed to its pledge to leave every penny of the surplus intact until reforms are enacted. The President's budget proposed new initiatives in a number of key areas, including child care, education, the environment and health care, but all of the proposed initiatives were paid for so that they would not deplete projected surpluses.

It should come as no surprise that Americans are eager to fix Social Security, because it is an extremely successful social program. For almost 60 years, Social Security has provided Americans with income security in retirement and protection against loss of family income due to disability or death. Social Security retirement benefits are indexed for inflation and provide a lifetime annuity--a package which is difficult if not impossible to obtain in private markets. In fact, less than half of all individuals aged 65 and older received any private pension benefits in 1994. As a result, Social Security benefits are the largest source of income for 2/3 of those in this age group and the only source of income for 18 percent of them. The system has enjoyed dramatic success in reducing the poverty rate among retirees, helping to lower the elderly poverty rate from 35 percent in 1959 to 11 percent in 1996. Social Security is also more than just a

pension plan: It is a family protection plan, and nearly 1 in 3 beneficiaries are not retirees. For the average wage earner who dies and leaves a spouse and two children, Social Security provides survivors benefits equivalent to a $300,000 life insurance policy; one in six 20 year olds will die before retirement age. Social Security also provides disability protection, and 3 in 10 20 year olds will become disabled for some period before retirement.

The most commonly used yardstick to measure the financial soundness of the Social Security system is the 75-year actuarial balance. The Social Security actuaries now project that the current balance in the Trust Fund together with projected revenues over the next 75 years will be insufficient to fund the benefits promised under current law. By 2013, payroll contributions are expected to fall short of benefits; by 2021 the shortfall is expected to exceed Trust Fund interest earnings, so the Trust Fund will begin to decline; and by 2032, the Trust Fund is expected to be depleted, after which time contributions would still be sufficient to pay about 75 percent of current law benefits. Of course, future taxes and benefits depend on a variety of economic and demographic factors that cannot be predicted perfectly, so the actual problem may be smaller or larger than we now believe. Nevertheless, the intermediate projections of the actuaries imply that the imbalance in the Old Age, Survivors' and Disability Insurance program over the next 75 years amounts to around 2-1/4 percent of taxable payroll, or about 1 percent of GDP. That is the most common way to scale the current problem. As the CEA noted, however, in its 1997 Economic Report, the 75-year actuarial balance actually understates the financial imbalance over the very long term because the actuaries' projections show surpluses in the early years of the 75 year horizon and growing deficits later on when demographic forces have their full effect.

Although Social Security faces a financial imbalance, poll results suggest that the magnitude of the problem has been exaggerated in the minds of many who report that they doubt that Social Security will be there for them at all. In fact, although the seriousness of the financial imbalance facing Social Security should not be downplayed, its magnitude is not so large as to be insurmountable, particularly if early action is taken. This is a solvable problem, and many ideas have been and will be put on the table to address it.

The President has emphasized that at this stage in the national debate he remains open-minded and committed to giving every option a fair hearing. It is far too early to prejudge the outcome of the debate. However, the President has set forth five principles to guide the reform process, reflecting his judgement about the appropriate goals for reform. His first principle is to strengthen and protect Social Security for the 21st century. This is an overriding goal, and it warns against proposals that fail to provide a comprehensive solution to the solvency problem. For example, a proposal that simply diverts existing payroll taxes into a new system of individual accounts would not qualify as a comprehensive solution because it reduces Social Security's revenues and makes the existing imbalance even larger. However, several comprehensive proposals have been advanced that include such individual account carve-outs.

A second principle for Social Security reform is to maintain fiscal discipline--to insure that surpluses are not drained before addressing Social Security reform, and that fiscal policy plays a helpful role in preparing for the retirement of the baby boomers. The key factors contributing to the projected Social Security imbalance are improvements in life expectancy and a reduction in birth rates, which have put us on a path of rapid declines in the number of employed workers for every retired American. When the Social Security Act was passed in

1935, the life expectancy of a 65 year old American was about 13 years. Today, life expectancy for a 65 year old is 18 years and rising. At the same time, people are retiring earlier. In 1950, the average age for first receiving Social Security retirement benefits was 68; today it's 63. As a consequence of these changes, the ratio of employed workers to retirees has fallen from about 5 to 1 in 1960 to 3-1/2 to 1 today. In only 30 years time, it will be just 2 to 1 and still falling.

In addition to the aforementioned effects on OASDI, this demographic transition will have important effects on the Medicare and Medicaid programs as well as on the economic environment outside the government. For the nation as a whole, the central problem is to provide a high standard of living for both workers and retirees even though a smaller share of the population will be in the workforce. A natural solution is to make workers more productive by increasing investment in both physical and human capital, which will, in turn, raise labor productivity. In doing so, we can boost the size of the total economic pie, which is the prerequisite to meeting the retirement costs of the baby boom generation without unduly burdening future workers. The key to accomplishing this is to increase national saving, a goal to which continued fiscal discipline would contribute.

National saving increased from 3.4 percent of net national product in 1992 to 7.6 percent in the first half of 1998, but the improvement is accounted for entirely by the elimination of the federal budget deficit, as private saving actually declined relative to total output. If the projected budget surpluses are saved, they will add to national saving; moreover, $130 billion of surplus placed in the Trust Fund and invested in government bonds would extend the expiration date of the Trust Fund by roughly a year or reduce the taxable payroll gap by about 0.1. National saving could also increase if the surpluses are used to fund individual accounts and such accounts add to

private saving. But if the surpluses are dissipated, they will neither help to strengthen Social Security nor add to national saving.

The President listed three other principles to guide Social Security reform. One principle is to maintain universality and fairness. The current program provides benefits on a progressive basis, and ensuring progressivity is an important standard by which reform proposals should be judged. Another principle is to provide a benefit that people can count on--a secure base for retirement planning. I will come back to this principle of retirement income security when I discuss some prominent reform proposals. Finally, the President has said that we must preserve financial security for low-income and disabled beneficiaries, which highlights his commitment to preserving the disability and survivors' insurance aspects of the OASDI program.

The President's principles will provide a framework for Social Security reform, but they do not precisely determine its outcome. Even within this framework, the President and the Congress will face some difficult choices in the coming months. I would like to discuss some of the issues and tradeoffs that will be important. Of course, I am not going to endorse specific reform ideas at this time, because the President has made it clear that he does not want to prejudge the public debate or hinder bipartisan consideration of alternative proposals.

One overriding question is whether to stick with the pure defined-benefit structure of Social Security or to move at least partly in the direction of a defined-contribution structure with individual accounts. Some people argue that individual accounts could earn a higher rate of return than the Trust Fund can, pointing to the difference between returns on average private portfolios and projected rates of return on Social Security. But this comparison is misleading in at least two crucial ways.

First, most of today's payroll tax goes to current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirements, we would need to find some other way to pay current benefits. Put differently, the Social Security system paid benefits to some past generations of retirees that greatly exceeded their contributions. This policy created an implicit debt that must be paid somehow by current and future generations, and a Social Security system which does that will necessarily generate a lower return than a new system that does not have that accumulated burden. This is often referred to as the "transition problem." Surpluses in the unified budget--used either to augment the Trust Fund or to fund individual accounts--could at least partially mitigate the transition problem, by bringing additional funds into the Social Security system.

The second way that comparing rates of return between average private portfolios and Social Security is misleading is that most private portfolios invest in riskier assets than does the Social Security Trust Fund. These riskier assets--equities in particular--have paid higher returns than government bonds over nearly all long periods of time in the United States during the past century. Between, for example, 1959 and 1996, the S&P 500 returned an average 3.84 percent more per year than bonds in the Trust Fund. There is no guarantee, however, that the equity premium in the future will match its historical average. And equity investments involve substantial risk over shorter time periods. For example, on three occasions during the past 70 years, the S&P 500 index has declined more than 35 percent over two years, while Japan's Nikkei index has fallen over 60 percent since 1989. Moreover, some analysts have questioned whether investing Social Security funds in equities--through either the Trust Fund or individual accounts--would have positive effects on saving or rates of return for the nation as a whole. If

such investments merely represented a swap of bonds for equities, there would be a corresponding swap of equities for bonds in private portfolios. If the total supplies of equities and bonds were unchanged, this exchange would raise the return earned on Social Security contributions but reduce the return earned on people's other retirement savings.

Of course, knowledgeable proponents of individual accounts understand these points and favor establishing such accounts for other reasons. Some supporters of individual accounts believe that national saving can be increased more effectively by moving funds out of the government and into private hands. They doubt that the government has the will to renounce the use of growing annual surpluses in the Social Security system. Some also argue that for many Americans without private retirement accounts, individual accounts established by the government could, through a demonstration effect, stimulate additional private saving. However, under current budget projections, individual accounts could not be funded out of the surplus forever, so a permanent commitment to their funding could set the stage for future fiscal deficits.

Many supporters of individual accounts believe that it is important to allow individuals to choose the portfolio allocation of their Social Security contributions. One justification that is offered for this view is that people should be able to decide for themselves how much risk they want to bear. However, at the same time, some supporters of individual accounts want the government to restrict people's investment options to reduce their risk, or they want the government to guarantee some minimum level of benefits while allowing scope for equity investments. Balancing flexibility against protection is a difficult problem.

Another justification that is given for allowing individuals to choose portfolio allocations

is to minimize government involvement in financial markets. Supporters of an "equities in the Trust Fund" approach argue that it can achieve the same objective as individual accounts with lower administrative cost and greater sharing of the risks of market fluctuations both within and across generations. I think it is an open question, though, whether institutions could be designed that would allow the Trust Fund to purchase equities but still ensure that the government did not gain too much influence over the economy. Depending on the share of the Trust Fund invested in equities, the Social Security system could end up holding a substantial fraction of the stock market. Could the government avoid the pressure to make investment decisions for purposes other than maximizing the rate of return while minimizing risk? How would stock proxies be voted?

In the Federal Thrift Savings Plan, governance issues have been handled successfully by insulating investment managers from political calculations, narrowly defining their goals, and permitting investment only in index funds. However, the Thrift Savings Plan involves far less money than Social Security does, and it is essentially a collection of individual accounts managed by the government rather than a government-owned Trust Fund. In considering these governance issues, we may benefit from studying the experience of other countries engaged in similar reform efforts. For example, the Canadian Pension Plan will begin investing in private securities in early 1999. Equity purchases will be restricted to indexes, the fund will not be allowed to hold more than 30 percent of the voting shares of any firm, and investment decisions will be made by a board charged with a fiduciary responsibility to manage the fund in the best interests of the contributors and beneficiaries.

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mentioned. Some opponents of these accounts worry about how to maintain Social Security as a progressive program that is fair to all Americans. For example, proposals to contribute a flat percentage of the payroll tax to individual accounts benefit high income workers the most. In contrast, proposals to use budget surpluses to make equal dollar contributions to individual accounts could be highly progressive.

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