Inclusion in Asset Building: Research and Policy Symposium

The Thrift Savings Plan Experience: Implications for a Universal Asset Account Initiative

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Elaine Rideout Fisher
Economic Investment Strategies, Associates
Apex, NC

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Center for Social Development
Washington University
George Warren Brown School of Social Work
Campus Box 1196
One Brookings Drive
St. Louis, Missouri 63130
Telephone: (314) 935-7433
Fax: (314) 935-8661
http://gwbweb.wustl.edu/csd
E-mail: csd@gwbmail.wustl.edu

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INTRODUCTION

Public policies that promote assets-- both personal and material-- as opposed to those that are deficiency-oriented, are catching on in America. Both President Bush and former President Clinton have expressed support for Individual Development Accounts (IDA's), a leading individual asset-building strategy. The accounts are established for low-income savers who are provided with matching contributions as well as financial education and counseling. To date, there are 300 community IDA programs in operation[1] and over 5,000 "working-poor" participants.[2] But proponents of the asset-building movement in America are grappling with a number of issues in their effort to take the movement "to scale." Interestingly, a number of these issues are very similar in nature to those faced by the nation's now widespread capital accumulation movement, which essentially began in 1981 when the IRS released rules for the establishment and implementation of 401(k) retirement savings plans. Specifically, the development and establishment of the government's own 401(k)-style Thrift Savings Plan (TSP) for Federal employees in the mid-1980s offers a wealth-builders a particularly relevant case-study-in-scale. Today, section 401(k) is probably the best-known part of the US code. And the TSP has become the largest 401(k) in the world.

What can the asset-building movement learn from the earlier revolution that produced the capital accumulation movement? What can be learned from the process of innovation that led to the successful establishment of the Thrift Savings Plan? The three-year effort that culminated in the TSP "privatization" of a portion of the Federal Civil Service pension hashed over a number of issues and concerns. Some of these concerns are relevant today in the context of asset-building policy expansion, as well as to reformers advocating individual Social Security accounts. They include the following:

Poor People Don't Save--How effective are savings and asset-building tools geared to populations that are the least able to save, and what measures are necessary to secure equal access and equally **proportional participation across income levels?**

Funding--To universal public asset-building policy proponents, a dedicated, sustainable funding stream is essential. The approach requires an enormous up-front investment of capital, and the pay-off is long-term—from several decades away, to an entire generation hence. How can such a thing be achieved in a time when budgets are debated annually, and the "long-run" is five years away? Reformers of the old Civil Service pension, which was funded on a "pay-as-you-go" basis like Social Security is now, found forward-financing the individual TSP accounts to be a particularly difficult challenge.

Central vs. Decentralized Administration--How should asset-building programs be administered? Should they be employer-based? If so, what about self-employed and non-working savers? Should investments and account management be centrally managed or should they be decentralized, as IRA's currently are? How do policymakers ensure that all savers receive consistent, comprehensive information that will allow them to make well-informed investment decisions? How do they ensure that management fees are not so excessive as to undermine essential returns?

Government Interference in the Private Marketplace--If the government is managing investments, how can that be done without "meddling in the marketplace" and compromising the independence of American private enterprise?

Risk--How can policy designers mitigate investment risk? How do they help ensure that savings invested in the financial markets will not be mis-managed or even destroyed? How do they make sure investors make "prudent" investment choices?

All of these issues, and more, were hashed out over three years of Federal pension reform deliberations, in a highly-charged partisan environment. In hindsight, it is still hard to believe that out of such an environment, a bipartisan consensus, the Federal Employee Retirement System Act of 1986, could emerge. The newly-minted pension system that resulted could not, in contrast, be any less controversial today. For employees at all income levels, the Thrift Savings Plan is among the most beloved of all Federal benefits. Its example, and its very existence holds much promise for replication by wealth-building reformers. This paper explores how the founders of the TSP resolved the issues raised above, and applies these "lessons learned" in identifying optimal strategies for the development of a large-scale, comprehensive, national asset-building policy.

BACKGROUND

The Capital Accumulation Movement--Before the capital asset-building movement in America, of which Individual Development Accounts (IDA's) are but one of the better-known strategies for helping move the economic underclass into the mainstream of asset-holding society, there was the capital accumulation movement. While the objective of the asset- building movement is the immediate accumulation of non-financial capital assets, the primary objective of the capital accumulation movement was, and is, capital asset accumulation for retirement security. Today, the primary vehicle for capital accumulation is the defined contribution plan. Defined contribution plans continue to displace traditional defined benefit-style employee pensions. (Traditional "defined benefit" plans define the benefits of workers while defined contribution plans define only the "contribution" of employees and employers). Employees "self-direct" most defined contribution plans; they make investment choices, typically, and the value of their final benefits depends on how successfully they invest their account balances. The investment risk, in other words is born by the employee instead of by the employer. (Under traditional defined benefit plans, employers are held responsible for producing returns that would be adequate to pay for the specific benefits promised in accordance with individual wage and service criteria). Defined contribution plans today include IRA's, CODA profit sharing plans, SEP's, ESOP's, MSA's, ESA's, KEOGH plans, and section 401(k), 403(b) and 457 retirement savings plans.

The capital accumulation movement took off in 1981 when the IRS released the rules and regulations for the establishment of 401(k) plans. The 401(k) plan was essentially an "update" clarifying the pre-tax status of earlier CODA profit sharing plans--either in cash or company stock. Profit sharing in the US began in 1797 when Albert Gallatin initiated a plan at his glass factory in Pennsylvania. A second plan was started in Massachusetts at the Bay State Shoe and Leather Co. in 1867. In 1887, when Procter and Gamble offered a profit sharing plan, labor unrest at the company disappeared. Other major corporations began instituting profit-sharing plans, including Eastman Kodak in 1912 and Sears Roebuck & Co. in 1916. And the Congress passed legislation permitting tax-favored treatment of the plans in 1921. Plan growth continued until the stock market crashed in 1929 when an estimated 70% of all profit sharing plans were discontinued. Companies did not begin to reinstate them widely until the 1940s. With the bankruptcy of Studebaker and the collapse of its pension plan, the Employee Retirement Income Security Act (ERISA) was enacted in 1974. But ERISA was unclear about the status of existing profit-sharing arrangements, which prompted the passage of Section 401(k) in 1978.[3]

Ever since, the nation's employers have moved inexorably away from traditional defined benefit plans to participant-directed defined contribution plans. But two other developments hastened the movement: increasingly complex government regulations, and the pressures of market competition.

Government Regulation--Many employers and employer organizations blame the government, itself, with unwittingly hastening the demise of the traditional defined benefit corporate pension. The Profit Sharing/401(k) Council, for one, attributes much of the decline of defined benefit pension plans to overly zealous oversight and the onerous regulatory burdens imposed by the Department of Labor.[4]

But US lawmakers' attempts to boost anemic US savings rates handed corporations an easy way out of the defined benefit regulatory thickets. As defined contribution plans became popular with employees, employers found it easier to eliminate or cut back on an expensive and hard-to-manage defined benefit plan on the one hand, if they could offer employees a savings, profit sharing, or stock ownership plan on the other.

Market Competition--But there can be no doubt that the forces of global competition, the stellar track record of institutional investors, and government rules that allow corporations to "capture" excess contributions to boost corporate balance sheets, has had a great deal to do with the number of defined- benefit to defined-contribution plan conversions. Many corporations have found that converting from defined benefit programs, with their dynamic and thus less-predictable actuarial financing burdens, to defined savings plans with their static cost predictability, has benefited more than just cash flows and budget projections. As market returns have swelled over the last decade, most pension funds (with the possible exception of public plans which are not subject to ERISA's strict actuarial soundness formulas) are either fully funded or over-funded. As defined benefits are slashed or discontinued in favor of the more predictable savings plans, company pension funds are even more flush with cash. Over-funded defined benefit plans have become a new company profit center, and excess funds are often diverted to invest in new plant and equipment; to help finance company stock buybacks, (which help prevent dilutions as corporations augment company pay with stock options); or simply to enhance the bottom line.

While the financial incentives to control costs and reclaim "excess" Plan assets are often too hard to resist, the ways of doing business have changed to favor the capital accumulation movement. Compensation packages have changed to fit new competitive realities and a modern workforce. Employees rarely spend an entire career at any one company, anymore. A mobile workforce places a high premium on portable benefits, and traditional defined benefits don't fit that bill. To remain competitive globally, US businesses are cutting back on workers and paring benefits, frequently by employing part-timers, short-term project workers, temporary workers, and independent contractors. They are also instituting profit sharing, performance-based pay, and other productivity-enhancing policies, and substituting equity for cash-based compensation.

In 1999, corporate 401(k) plans covered 55 million participants. A majority of US employers (87% of companies with over 100 employees) offer the plans as a way to save for retirement. Last year, according to the Investment Company Institute in Washington DC, workers had approximately $2 trillion invested in 401(k) plans, IRA's and other capital accumulation plans. These plans have become so ubiquitous, companies today need to offer the plans to attract and retain quality employees. For small companies, 42% of all employees participate in a plan.[5]

The overwhelming success and popularity of personal asset accounts like the 401(k) plan extends to the Federal Thrift Savings Plan, which, since 1987, has become the largest 401(k) retirement savings and investment vehicle in the world.

The Thrift Savings Plan--The Thrift Savings Plan (TSP), currently with over $100 billion in assets under management, was inaugurated in 1987, shortly after the enactment of the Federal Employee Retirement Savings Act (FERSA) of 1986. The Plan is a Federal employee benefit enrolling 2.4 million Federal employee participants, Members of Congress, Congressional staff, and military personnel. The Plan allows federal workers to supplement their Federal defined benefit pension with their own savings. Employees make voluntary contributions via payroll deductions and their employing agencies match a portion of their savings. Contributions and earnings are tax-deferred until withdrawn at retirement. Active participants may borrow against their accounts for certain purposes, including buying a home, financing education and medical expenses, and they may make limited emergency withdrawals.

Accounts are self-directed; e.g., participants choose how to invest their fund balances. Currently, participants have a choice of three investment funds, a Government Securities Investment (G) Fund, a Common Stock Index Investment (C) Fund, and a Fixed Income Index Investment (F) Fund. Additional funds, a Small Cap Stock Index Fund and an International Stock Index Investment Fund will be forthcoming later this year.

The TSP is administered by the Federal Retirement Thrift Investment Board (FRTIB), a small, independent Federal agency governed by a 5-member bipartisan Board of Directors and a private-sector-style CEO appointed by the Board. The FRTIB is unique among Federal agencies in that its Board and Executive Director serve as fiduciaries. They are required by law to act prudently and solely in the interest of Plan participants and beneficiaries. Because all of the funds held in trust by the Plan belong to participants, and not the government, this management structure was established in order to ensure that the Plan would be free of political or social interference. To ensure the fiduciary accountability envisioned by ERISA and reinforced for the TSP in FERSA, the FRTIB is an "independent" governmental entity, exempted from most of the normal terms and conditions placed on agencies of the Executive Branch of government. (Its operating expenses are not subject to budget review, for example). While the Board is independent of Executive or Congressional interference, it is subject to alternative forms of strict oversight, including that of a 14-member Employee Thrift Advisory Council representing Federal employee unions and other employee organizations, a fiduciary compliance audit by the Department of Labor, and oversight audits by a private accounting firm and the General Accounting Office.

The FRTIB serves participants primarily on a "wholesale," as opposed to a "retail" level. It relies on an extensive network of retail outlets (agency personnel offices) to educate (not "sell") employees about their options under the Plan. The employing agencies' personnel, payroll, and other administrative officers are responsible for employee counseling, for Plan enrollments, and for the accurate and timely transmission of participant data to the Plan's record-keeper, a government data processing operation at the Department of Agriculture. The record-keeper also administers a centralized Plan Service Office which serves agency staff as well as separated, retired, and other Plan participants directly, processing everything from address changes to investment allocations and reallocations, disbursements, court orders, IRA rollovers, etc.

The Asset–Building Movement--But unlike the capital accumulation movement, where tools and institutions like the TSP are well established; the similar potential of asset-building tools such as Individual Development Accounts (IDA's) are only beginning to be widely recognized. IDA's and 401(k)'s are closely related. Both (usually) include a savings matching component. While IDA savings have (to-date) been matched by governments, employers, and charitable organizations, 401(k)s are matched by employers. The chief differences are, IDA's have no pre-tax benefit, and 401(k)'s do not allow for pre-retirement withdrawals for asset-building puposes, (although loans are allowed). Like the TSP and most capital accumulation plans, IDA's require the active involvement of participants who are equal players in the process. The participant must save money out of his/her own paycheck (via payroll deduction, usually, for 401(k) participants). He/she must manage his/her own investments and decide the degree of investment risk he or she is willing to take. Both types of account holders typically receive financial education and counseling.

Currently, there are over 5,000 participants enrolled in IDA's nationwide. The programs are supported administratively by governments, private foundations, nonprofit service providers, and private financial institutions. Evaluations of participation in IDA programs conducted by the Corporation for Enterprise Development (CFED) have led them to conclude that IDA programs "return" five times the cost of their initial investment in the form of new businesses, new jobs, increased earnings, higher tax receipts, and reduced welfare expenditures.[6]

In addition to IDA's supported by CFED's American Dream Demonstration initiative and the Federal Assets for Independence Act (AFIA), other self-directed savings tools that facilitate asset-building are beginning to crop up spontaneously across the country. Under current law, employers may choose to match "Flexible Spending Accounts" (FSA's) used for IDA-type purposes. Employers have even implemented "reverse IDA's" financed through 401(k) programs. The Town of Cary, NC, for example, projects forward an employee's 401(k) account balances, and advances up to 90% of that amount for the downpayment of a new home. Employees' 401(k) and matching contributions pay back the cash advance. Employees benefit from the 401(k)'s tax status, as well as via the rapid appreciation of housing values in the Cary area. In another example, a Baltimore web design firm augments employee savings efforts with a $15,000 down payment on homes that are within walking or biking distance from the firm.

LESSONS LEARNED

The evolution of the capital accumulation movement, and especially of its largest success story, the TSP, offer asset-building practitioners and policy advocates a ready-made example of a savings innovation taken quickly and successfully to scale. The TSP experience may hold valuable insight for wealth-building reformers as they attempt to do the same.

For the TSP, (as it is for today's IDA proponents), the biggest obstacle was the naysayers' favorite mantra — **"Poor people don't save".** "How can you expect the lowest-paid federal workers to save," the critics argued, "when they have nothing to save with?" It is easy to design retirement savings vehicles for the rich. But how do you design a savings plan that is inclusive—that benefits the poor as well as the rich? Don't savings plans, by definition, benefit the "haves," who already have assets, at the expense of the "have-nots" (especially if there are Federal matching subsidies involved). By subsidizing the growth of capitalist wealth, aren't we, by definition, excluding our poorest citizens?

One solution identified by the FERSA framers to this dilemma was a "front-loaded" government match of employee savings. All new employees under the Plan receive an up-front contribution equal to 1% of their salaries. Then employee contributions up to 5% of salary are matched on a graduated scale from 100% to 50%. While <u>all</u> low-income FERSA employees (those earning between $10,000-$19,999) have TSP accounts, over fifty percent are also active savers (via payroll deduction). Since only approximately 22% of these workers saved at the inception of the program, it is likely that the match, plus FRTIB's personalized education and service efforts, have helped to encourage active participation at the lowest income levels. Many of the lowest-paid federal employees are new hires. FRTIB statistics show that in 1998 (the latest numbers available) 78% of the youngest Federal workers (aged 20-29) participated in the Plan. Participation among that cohort has increased each succeeding year since the inception of the Plan.[7]

The success of the TSP in attracting active participation at the lowest levels is likely due to a combination of factors beyond the matching contributions, including the automatic enrollment and upfront contribution, retail education that targets each individual participant, the convenience of tax-deferred saving via payroll deduction, and favorable investment returns/low costs. Of particular relevance to wealth-builders, the TSP experience would suggest that IDA's with similar features could attract even higher participation rates, given the shorter-term pre-retirement nature of the asset purchase goal. Early results from a number of IDA experiments seem to be bearing this out.

Resolving **funding** obstacles was critical to the development of the TSP. Because the Civil Service Retirement System was funded on a pay-as-you-go basis (like Social Security), incoming tax receipts were used to pay outgoing benefits. In other words, current payroll tax withholdings were used to pay the monthly benefit checks going out to retirees. But unlike Social Security, the CSRS was, at that time, a "mature" system, (the incoming pipeline population roughly matched the outflowing). And there was no "budget surplus" to help pay for reforming the system. FERSA reformers had to find a way to forward-fund the new benefits (TSP matching and tax benefits) without increasing the payroll tax. Eventually, they agreed that the new TSP employee contributions would have to be made on top of existing payroll taxes (as opposed to diverting any of these taxes to TSP and away from the base pension benefit). And the cost of employer matching contributions was partly paid for with savings realized by cutting some of the program's defined benefits (the retirement age was raised, for example). Furthermore, (although it didn't, in the end, benefit the pension fund's actuarial balances), new G-Fund employee investments marginally enhanced the government's ability to internally manage the national debt.

Like asset-building reformers, framers of the TSP also wrestled with the issue of **central vs. decentralized administration.** Should the TSP be centrally managed or should it be voucher-like, where funds are transferred to IRA managers or local financial service providers? Ultimately, the sizeable economy of scale advantages to a single, central provider (the FRTIB) won out. A central provider can ensure the production of uniform disclosure and investment education materials and manage material distribution. A single provider can spread management costs over a larger contributor base, and, by narrowing investment choices, reduce transaction costs.

TSP administrative expenses have turned out to be even lower than was ever anticipated by the framers of the Plan. According to the FRTIB, expenses are down to approximately .06% (60 cents per $1,000 balance). This compares very favorably with the .26%-.49% fees charged by the giant New York-based pension plan for educators (TIAA-CREF) for its no-load mutual funds, which are now open to all investors. In contrast, active portfolio managers typically charge in the neighborhood of 2% a year for services including investment research, trading commissions, and management costs.

Administrative costs of the TSP are offset by the profits C and F fund investors make on securities lending by the investment manager. The massive scale of the Plan nearly eliminates costs, in addition, because the Fund is able to cross-trade with other large institutional investors. Cross trading minimizes "market-impact" costs, or the impact of other traders moving market prices in reaction to block trades. As electronic trading networks expand, very large institutional investors will be able to more efficiently cross-trade anonymously, thus boosting liquidity and eliminating transaction costs. Anonymity allows institutional investors to sell large blocks of stock with little market impact repercussions because buyers don't vanish as word leaks out that the "smart money" is selling).[8]

The centralized management model also avoided the risk of unscrupulous commission-hungry brokers duping participants out of their hard-earned savings. National British "personal pension" reforms that occurred at approximately the same time as the FERSA, blew up into a nation-wide scandal when it became apparent that private service providers persuaded many participants to "opt out" of the public system and forfeit employer matching contributions. Participants were then sold high risk, high expense investment schemes that inevitably left them much worse off than they were before the "reforms" were enacted.

On the other hand, a centralized system does restrict choice, including participants' ability to take advantage of new product innovation. The framers of TSP considered the advantages in reduced risk and capital preservation (some of it tax-payer dollars) to be well worth this cost. For asset-builders, the decision is not so clear-cut, given the low cost of some of today's more innovative financial products. (For example, new index securities and Exchange Trade Funds (ETF's) allow retail investors to "buy" the performance of markets or a given industry or sector of the market. And investors buying US Treasury bonds directly from the government under the Treasury Direct program pay nothing in investment costs). Thanks to the size and track-record of the financial services industry in general, more large funds are beginning to wave minimum balance requirements which, until recently, was a practice exclusive to TSP and TIAA-CREF-size funds.

For asset-building investors, capital preservation is doubly important because of the relatively short duration of these investments; they must be cashed-out long before retirement. For this reason, it would be hard to find a better investment alternative than the TSP's centrally-managed G-Fund. The Fund earned a no-risk 7% compounded annual rate of return between 1990-1999.[9] To best match that, an IDA participant would have to find an FDIC-insured short-term CD that paid substantially more (given bank management fees).

Asset-building policymakers might consider a "hybrid" combination of a centrally-managed G-Fund-type "default" option for asset-building investors without local access to high-return, low-fee investment opportunities, and a decentralized option offering a more comprehensive menu of passive fund choices for longer-term investors who either don't qualify for an asset cashout, or for those who already purchased their asset and were continuing to save through the program. The government could issue criteria that would help limit investor choices to specific categories of private funds, (perhaps only those like TIAA-CREF with minimal fees) just as the FRTIB selected TSP investment funds in accordance with prudent risk, return, and diversification criteria. Financial service providers whose products met the criteria could compete to become "certified" providers of IDA-type products. (Private scorecards, such as Morningstar's five-star rating system, could serve this effort, as well).

While the advantages of a single provider of financial and investment education materials are formidable, it is equally important that advice and support be available at the retail level. This is especially important in a low-income IDA-context. But the extensive, comprehensive, and one-on-one support that is best suited for this population would be extremely expensive to administer, and could, if not carefully designed, significantly offset asset-holders' investment gains. For this reason, program designers should consider identifying a separate funding stream to support this expense (for example, maintain funding levels of local social service agencies even while welfare rolls shrink to offer this service; or, provide tax breaks to local financial institutions willing to provide these educational services). But this is more than just a low-wealth issue. Arguably, financial education in general is an issue requiring the attention of policymakers. Across ALL incomes, financial education is even rivaling health care cost concerns of US employees. Surveys show that 60-90% of all US employers provide some sort of financial education to workers (much of it in the form of "freebies" from financial service providers). According to a study cited by the Conference Board of New York, for each dollar employers spend on financial education, they receive $3 back.[10]

Anytime anyone suggests investing **government funds in the private marketplace**, be it for the TSP, asset-building programs, or Social Security accounts, he or she invites charges that the government will soon be meddling in corporate boardrooms. The framers of the TSP grappled at length with this issue, and ultimately resolved it to the satisfaction of both political parties by, among other things, prohibiting proxy voting. In addition, Plan investment choices are limited to "passive" stock and bond investments. Passive fund managers do not try to outperform the stock market but simply aim to match a broad market's performance. Because TSP Fund managers invest in index funds replicating broad market performance, they are not tied to the fortunes of any one particular company. The FRTIB selects the index fund that best fits the FERSA statute and the needs of participants and beneficiaries. It contracts with a private commingled index-fund provider which best meets a series of criteria including: tax-exempt assets under management, personnel and years of experience, tracking and trading performance, custodial service, fiduciary record, and fees.

Passive investing also mitigates risk because investors' fortunes are tied to the performance of the market as a whole, rather than to any one company. **Risk** is always a major concern of savings plan participants because they (not their employers) suffer the consequences of bad investment choices. Early critics of the TSP asked, (as IDA and Social Security reform opponents ask now), "What happens if the money isn't there when it's supposed to be?" And, "How can I optimize the returns on my hard-earned savings?"

The framers of the TSP and FRTIB fund administrators, have, in addition to nearly eliminating fees, minimized risk/optimized returns through a number of strategies. The Plan's G Fund, for example, invests in short-term non-marketable US Treasury Securities (issued specially to the Plan). The yield is established by statute--the average of market rates of return on US Treasury marketable securities outstanding with four or more years to maturity--the same rate allocated by the US Treasury to the Social Security and Civil Service Retirement Trust Funds. The G Fund is invested, though, in securities with a one-day maturity—thus avoiding the interest rate risks typically associated with government bonds (the risk of changes in the value of the underlying securities as market interest rates change).

Another way TSP investment risk is managed is through investment diversification. Asset allocation techniques help diversify investment portfolios, and sophisticated derivative hedging tools are used by professional fund managers to mitigate risk. Through established investment policy objectives, the Plan provides investment vehicles that allow TSP investors to diversify their portfolios by choosing to divide their assets among the Plan's investment funds. Currently, the Plan offers the risk-free, short-term (G Fund), equities (the S&P 500 index), and intermediate and long-term debt securities (the Lehman Brothers US Aggregate (LBA) bond index). In the near future, the Board will also offer investors the opportunity to broaden their portfolios into small cap and overseas indexes as well.

What TSP investors do NOT have is the option to invest through the Plan in "active" funds where managers invest in companies they may consider to have "value," meaning their shares seem cheap in relation to the firm's current profits; or, "growth" stocks that have momentum or the potential to become major market players. Active money managers charge more for their services, but they cannot, on average and over any sustainable period, outperform passive investing approaches. An index simply measures the average of what all stocks are doing. By definition, all investors collectively cannot beat an average, since taken together they are the average. In fact, according to a study by Barclays Global Investors, approximately 80 per cent of active managers' investment performances trail the index.

Lately, however, as investors pile into index funds, contrarians wonder whether the approach is becoming inherently more risky. The S&P 500, for example, they say, has become insufficiently diversified across market breadth; it is too focused on a small number of stocks; by including only large company stocks it has become top-heavy; and it's dominated by a single sector--technology. Yet, today's S&P is about as diversified as it was 20 years ago. It isn't that narrowly focused because it represents 77% of the US stock market value. Furthermore, if the market is getting riskier, deviating from the market's weighting is also risky. Last year, for example, just seven names provided half of the S&P's rise. NOT investing in those seven would have been unprofitable. Investors concerned with the diversification of the S&P can always invest instead in the Wilshire 5,000 index, which includes most regularly traded large and small company stocks.[11]

Of all the TSP's achievements to-date, possibly of greatest significance has been the unequivocal demonstration that there is indeed a fiscally prudent and socially appropriate occasion for the controlled (via independent fiduciaries) investment of tax dollars in the private market economy. When it comes to honoring individual choice while minimizing participant risk and optimizing participant returns, the FRTIB's track record proves that it can be done, it can be done ethically, and it can be done well.

POLITICS OF REFORM

The political environment that existed in 1986 was crucial to achieving the bipartisan support that lead to the enactment of the FERSA pension reform that also gave birth to the TSP. Several factors coalesced that ultimately favored a fairly drastic overhaul of the Civil Service pension program, instead of (what is usually the result of partisan gridlock) piecemeal band-aid approaches cobbled together to keep badly under-funded "entitlement" programs financially afloat.

In the early 1980's, the CSRS faced twin threats: a solvency crisis, with rapidly escalating unfunded liabilities; and, an identity crisis. The Federal government had conducted an analysis of its employee compensation package against those of comparably-sized private employers. The CSRS pension, which had been designed for a workforce of predominantly male breadwinners locked into 30-year careers with the Federal Civil Service, was found to be hopelessly outdated in comparison with modern corporate pension plans. (Today, a new generation of workers are beginning to question the structure of Social Security in much the same way!).

The opportunity to modernize the CSRS arrived with coincidental legislation that brought new Federal workers into the Social Security program to help shore up its solvency. But while the legislation covered new Federal employees under Social Security, it did not remove them from the Civil Service program. In order to avoid "double jeopardy," where these workers' paychecks could be docked for both Social Security and Civil Service payroll taxes, a new Civil Service pension benefit had to be developed that more closely resembled a modern corporate pension supplemented by Social Security. Self-imposed Congressional deadlines to prevent "double jeopardy" provided momentum and helped bring discipline to the process. While both parties favored reform, their reform goals were different. Republican backers and the Reagan Administration wanted privatization, accrual financing, and benefit reductions that would reduce the mounting liabilities of the expensive CSRS pension. Democrats (backed by Federal employee unions) didn't want to cut program benefits or costs, but they wanted to enhance program portability in recognition of a modern workforce that included women, short-term, and younger workers who benefited little from the old CSRS.

Today's political climate, with respect to asset-building policy objectives, offers a similar, converging opportunity. Because of the large number of legislative policy priorities that complement the wealth-builder's agenda, the political climate for achieving bipartisan support of asset-building tools and objectives couldn't be better. Today's confluence of issues that lend themselves to wealth-building legislative solutions include ongoing earnings and wealth gap concerns, low savings rates, and social services/welfare, tax, and pension (including Social Security) reform initiatives. The latter three reform agendas are especially promising, given the near-term likelihood of a policy vehicle, and given the propensity of these reformers to be receptive to input from wealth-building proponents.

Earnings/Wealth Gaps—The wealth divide between the "haves" and "have-nots" has grown to where the assets of the top 1% exceed those of the lower 95% of all Americans. According to the Congressional Budget Office, during the 1990's, the highest-paid fifth of the population enjoyed inflation-adjusted wage gains of 15%, while the poorest 20% actually saw their real wages decline. The booming stock market and equity compensation schemes of the 1990s exacerbated the historical gap, by disproportionately rewarding wealthy investors, while the lower quadrant, with no assets to put at risk, received no benefit from the 90's stock run-up. Federal Reserve data shows that median net worth (as measured by assets and earnings) for Hispanic, African-American, Asian and other minority families was $16,400-- less than one-fifth that of the $94,900 median net worth for non-Hispanic white families. The racial divide in wealth--the value of all assets including homes, cars, stocks, and savings accounts--was even greater than that of income. Median income for non-white and Hispanic families was $23,300 in 1998, 61.8% of the white median income of $37,700.[12]

Aside from wage-based educational attainment differences, many analysts believe that much of the gap may be explained by differences in the two groups' financial behavior. It takes money to make money, and whites inherit far more money than minorities. According to an annual survey conducted by the University of Michigan, whites were three times more likely to have inherited more than $10,000 in the previous five years than blacks. Minorities are less likely to invest in the stock market and other higher-risk investments, which have generated much of the nation's new wealth in the past decade. While nearly half of all whites own stocks, approximately 11% of blacks do. Researchers also point to the fact that minorities are less likely to own their homes. Homeownership for blacks and Hispanics is under 50%, while homeownership for whites is over 72 percent. And, according to studies by the Joint Center for Housing Studies at Harvard University, minority home-owners' homes tend to appreciate much less quickly than those owned by whites, making it harder for them to build the equity needed to fund major purchases or refinance more expensive loans.[13] Historic patterns of discrimination in wages, job opportunities, and access to credit have meant that African American and Hispanic families have had less time to build wealth and pass it on to succeeding generations. Given that the wage gaps between senior executives and workers will only widen, the serious attention of lawmakers to policies that improve low-income and minority access to capital and asset-building is long overdue.

Savings Rates--Historically, US savings patterns have fallen to an all-time low. Since World War II, the US savings rate has fallen from an average of 7.7% of GDP in 1945 to a –0.9 percent in November, 2000, the lowest rate ever recorded since the Commerce Department began keeping monthly records in 1959. With this new low, policy makers will be looking even harder for policy strategies to boost America's anemic savings rate. Incentivizing investment and saving not only improves productivity, but promotes sustained economic growth.

But even while new ways to promote productivity-enhancing savings and investments are an economic imperative, little effort has been made to-date, on any significant scale, to target these policy tools to the lowest income wage earners. While, as individuals, the working poor usually do escape notice, the power of this untapped sector moving en-mass into the financial marketplace for the first time would be unprecedented. A large infusion of "new" investment capital, from a here-to-for unknown and invisible sector of the population that has never saved before, could take the economy, and the country, to new heights of prosperity.

Social Services/Welfare Reform-- As has occurred with the movement of pension policy toward the end of the century, the Social Welfare policies of governments, both at the macro and grass-roots levels, have been inexorably moving in an **inclusive**, participatory direction. Examples across the political spectrum include welfare reform, the school-choice and charter schools movement, the Assets for Independence Act, and the "New Markets" initiative. Inclusive government systems do not impose government solutions upon "beneficiaries"; they empower them to become active participants in the process. These systems are more participant-directed on the front-end than conventional government programs because they require client beneficiaries to take risks and make active choices, as opposed to being passive followers of government rules and mandates.

Participant-choice programs are very different from traditional ***exclusive,*** or externally-imposed government systems. Welfare recipients today, for example, take on some of the responsibility of finding a job, and some of the risk in the event they don't. In the old entitlement-dominated world of AFDC, indigent beneficiaries or "clients" were recipients of some level of subsistence support because of their failure to pass "means tests." Recipients were not "equal" or even "partners," as they had no say in the process, other than to "game" the system to maximize individual benefit levels (by remaining unmarried, or getting divorced, for example). The system, while well-meaning, established a culture of dependency even for those who were able-bodied without mental or physical disability. Individual lifestyle choices became motivated by fear—the fear of losing subsistence benefits. Pursued to its logical end, the "system" ultimately curtailed honest endeavor and robbed its beneficiaries of their self-respect, undermined "beneficiaries" of self-advancement opportunities, and essentially trapped them in a vicious circle of poverty and misery.

Because participant-choice centered Social Service reforms across the policy spectrum (from health to food, jobs, energy, housing, education, etc.) emphasize individual strengths, or assets, (as opposed to deficiencies), they harness individual and entrepreneurial energies. Thus these policies are more likely to draw sustaining energy from the competitive power of micro-economic activity and macro-economic capital markets, and they thrive **within** the systems and conditions of private enterprise. They incorporate checks and balances between the parties involved. The programs are successful because, with multiple parties sharing allied interests, it is almost impossible for them to fail. Participant choice programs are, by definition, also *risk-sharing programs*. The government, like the other component parties of the system, assumes some responsibility and risk, but it does not shoulder the entire burden alone. Other partners, aside from individual participants, may include employers, financial institutions, corporations, nonprofits, and others. While the government's administrative role may, as a result, be smaller, it more importantly serves to help ensure the accountability and the ongoing integrity of the system as a whole.

Tax Reform— Just as IRA's and 401(k)s came into being via legislation amending the tax code, the same approach offers promise to wealth-building promoters. One approach with widespread bipartisan support in Congress is a tax incentive for financial institutions to match the savings of low-income savers. In addition, there is widespread Congressional support for IRA expansion legislation. It could include 401(k)-like provisions with tax credits that would match the savings of lower income savers. While similar proposals in the past have targeted retirement savings, as opposed to near-term asset-building, liberal loan and cash-out provisions could make it similarly effective.

The Bush tax cuts could also present an opportunity for wealth builders. Given the ever-increasing projections for the Federal budget surplus and simultaneously eroding economic indicators (an economic contradiction in terms!), even Alan Greenspan has come out in favor of tax roll-backs. In order to help offset the public impression that the tax cuts will produce a windfall for the rich, some lawmakers will be looking for ideas of ways to spread the benefits of the cuts to low-income Americans (who pay relatively little income tax).

Social Security Reform--Updating Social Security so that it meets the needs of a 21st century workforce is not a matter of "if" but "when." Younger Americans, especially, are beginning to view Social Security as a bad deal for them. Those under the age of 35 will pay a lifetime of taxes and in return will probably (given demographic and fiscal realities) see substantially reduced benefits by the time they hit retirement age. Even if they collect benefits similar to those provided under today's law, they will have paid so much in taxes at today's high rates that only the poorest will see any investment return. Younger workers now entering the workforce provide an early glimpse at the workforce of the future. It is only a matter of time before they achieve the majority of votes needed to force "reform".[14] This new generation of workers, unlike their elders, are more likely to transient, independent, self-employed, and, more likely to enter and leave the workforce at will for family obligations or intermittent continuing education. They accumulate retirement credits haphazardly over the course of a diverse, multi-careered work life. Many are already behaving in ways that demonstrate their lack of faith in Social Security. They are, more than any generation before them, taking advantage of the tax code and retirement savings accounts offered by their employers.

Other Pension Reform--In a possible Social Security precedent-setting move, in July, 2000, the House Ways and Means Committee cleared a bi-partisan plan, also supported both by the railroad industry and the rail unions, which would invest part of the system's revenues in private market securities. The Fund's investments would be monitored by an independent Board, which would contract with Wall Street financial institutions, along the lines of the FRTIB. While employee payroll taxes remain unchanged from the current level of 11.2%, taxes could go up if plan investments lag, causing the program to go into an actuarial deficit. If returns excel, on the other hand, employees would receive a rebate of their "excess contributions." An initial investment of $18 billion in Plan assets in private markets, which represents a new budget outlay, would be financed out of the budget surplus or borrowed by the Treasury.[15]

Interestingly, the Railroad Retirement defined benefit/contribution hybrid proposal, corresponds closely with recent developments in the pension reform/conversion activity of large corporate pension providers. A highly visible corporate example of this approach is IBM's recent cancellation of a long-standing, generous traditional pension plan in favor of a controversial cash balance alternative. Cash balance benefit plans are also a somewhat "hybrid" combination in that they convert the "value" of the pension an employee has earned to-date into an actuarial present value, then the account is managed by the employer so that it "accrues" a fixed amount of interest that can increase by a factor associated with years of service. This latter provision, where the account is essentially guaranteed a rate of return (the employer retains some investment risk) is another way to address the "risk of return" issue associated with participant directed accounts, and no doubt will be an option that is addressed in the discussions of personal asset accounts and Social Security reform. While the IRS has slapped a moratorium on new cash balance plans, (IBM is accused of miss-selling the Plan while not informing older workers forced into the Plan that their benefits would be reduced); there can be no doubt that this type of hybrid approach is here to stay.

POLICY VEHICLES

Given that all of the above political and policy "agenda" items are aligned closely with the parallel objectives of wealth-building policy advocates, a number of legislative vehicles are likely to emerge that could "carry the water" for institutionalizing wealth-building policies and tools on a large-scale, sustainable basis. From among the potential allied policy initiatives, three candidate legislative vehicles appear closest in "shared synergies." The first "vehicle" is the ongoing federal social services/ welfare reform initiative. The second is tax reform, and the third is federal pension reforms, primarily Social Security reform.

Social Services/Welfare Reform--Just as the Thrift Savings Plan helped lead the way toward a new kind of old-age retirement security, asset and wealth-building approaches offer potential for a new kind of social order. Wealth-building tools have systemic potential via national legislation to further welfare reform objectives and those of other social service programs. Arguably, it is <u>essential</u> if welfare reform is to succeed over the long term. Unfortunately, while most able-bodied former welfare recipients are now working, many are finding that they are still unable to escape poverty. As time passes, these individuals may become as discouraged and depressed off welfare as they were on it. A matched savings program, coupled with economic and financial literacy components, would help to ensure they save, stay in their jobs, and have the incentive to continue to work hard (even at menial pay) for a better life for themselves and their families. Even minimum wage jobs could then be perceived as leading somewhere. Working at a fast food restaurant is not considered a dead-end job to those who dream of buying a franchise someday! Asset-building accounts, whether they are IDA's or reverse IDA's or some similar variant, would encourage low-paid employees to remain in the workforce long enough to advance over time. Likewise, the disincentive for not working would be enormous. Over time, participants would gain not only a downpayment for a home, or an education, or a business--they would have a wage history that would allow them to procure a mortgage, then leverage additional debt. Subsequently, as they gain skills and additional assets (the ability to finance a child's college education, for example), they will be ensuring that the next generation will be able to build upon the foundation of their parents' achievements.

A universal social services asset-building initiative for the working poor could be funded at the Federal appropriation level. In addition, the savings accumulating in State Temporary Assistance for Needy Families (TANF) programs could help finance matches and/or administrative expenditures. The savings in State unemployment funds may also be an appropriate funding source. While an IDA-like program for the working poor/former welfare recipients could be managed centrally at the Federal level, it could also be effectively administered through existing one-stop-shop local social service offices. The social service offices could provide "retail" client services, ensuring that recipients get the financial materials and counseling they need to participate successfully. They could refer their clients to eligible financial service providers.

If, as the Corporation for Enterprise Development has shown, IDA investments yield over $5.00 for each dollar invested, earmarking Federal surplus funds now for this effort will more than pay off in the long run. In the long-term, expenses will be offset, in addition to economic benefits, by the savings realized from other state and local poverty programs (housing, unemployment, community development, foodstamps, criminal justice, health care, etc.) which, as low-income families begin to move on to a middle class lifestyle, will have shrunk to serve only "safety-net" individuals who are physically or mentally incapable of helping themselves.

Tax Reform--In general, tax-credit approaches that incentivize savings for retirement, (such as proposed legislation expanding IRA and 401(k) limits), are ineffectual at lower income levels. According to the Heritage Foundation, most married couples who make less than $30,000 pay no Federal income taxes at all, nor do most individuals earning less than $21,000, thanks to the Earned Income Tax Credit (EITC). Tax credits may be of dubious value to the working poor who do not pay income taxes (approaching 40% of all households), and who pay much more in payroll (FICA) taxes than in income taxes.

The largest levy that 75% of all American families now pay is not the income tax but the regressive payroll tax. While income tax burdens, for most Americans, are lower than at any time in the past forty years, the payroll tax has increased from 3% in 1960 to 7.65% today, and payroll taxes account for 33% of total Federal revenues today, up from 12% in 1960. While the income tax is progressive (higher incomes are taxed at higher rates; the tax applies to all forms of incomes and has no upper limit; and low-income workers are exempted); the payroll tax is an exceedingly regressive tax. It is based on a flat rate, applies only to wages, kicks in at the first dollar earned, and largely exempts wages above $72,600. In addition to the 7.65% deducted from workers' wages, employers pay an additional 7.65% (which workers essentially absorb because wages are depressed accordingly). Self-employed workers and independent contractors pay the entire 15.3% themselves.[16] Add to that taxes on property, sales, and various state and local taxes and the poor are paying, despite the EITC, more than their fair share in taxes. (The EITC has a built-in marginal disincentive to improve family earnings above the EITC threshold. A single mother with two children making $25,000 finds her EITC reduced by 21 cents for each additional dollar of income. She loses another 23 cents to income taxes and FICA, and state income taxes come off on top of that).[17]

The cumulative effect of this overall tax regressivity allows the wealthy to pay a dramatically lower effective rate than the majority of working Americans. Fans of the FICA payroll tax argue that this is the correct way to finance a retirement system especially since Social Security becomes progressive upon payout, when the lower wage earners earn higher relative benefits. But why finance these "progressive" benefits by placing so painful a burden on low-income workers during the most cash-strapped times of their lives--when they are trying to educate themselves, build a household and a career, and educate their children? Isn't this a formula that actually helps ensure that at the end of their lives they will assuredly require the "rewards" of a progressive Social Security benefit formula? The fact that the Social Security "reward" awaits after a life of poverty and back-breaking effort does not negate the fact that governments (at all levels) are largely responsible for exacerbating the daily struggle that has consumed the lives of the working poor. Like every other American, low-wage earners would prefer the chance to improve the economic standing of their families now, rather than handing over their hard-earned money to a benevolent State (e.g. letting the government help further impoverish them to ensure they will be dependent upon its care in their old age). By then, a low-wage worker (who is probably also in ill-health) will have paid the full 15.3% freight for his/her "progressive" benefit while at the same time a highly-paid executive across town, who also pulls in a Social Security check, has paid an effective rate of 4.7%. His brother-in-law, a wealthy investor who lives off his capital gains, has never paid anything at all into the system.[18]

Poor people aren't paying income taxes; but they desperately need a payroll tax break. While tax credits to corporations to help finance and match IDA's (a proposal supported by President Bush) are a helpful first step, they may only benefit a limited number of recipients in urban areas. Besides, the corporate tax code is already riddled with loop-holes. Why exacerbate the trend of giving away the store to corporate America? Why not go directly, and universally, to the American people at the bottom of the heap-- it's simpler and more efficient to start with your target population, rather than an intermediary, when it comes to designing asset building tools to help build wealth and alleviate poverty.

Generally, tax credits, unless stated otherwise, are nonrefundable. This means a tax filer must have a tax liability to get the money back. Other than a reduction in the payroll tax, the only tax approach that would effectively reward the savings of lower-income people would be a refundable credit. With a refundable credit, no tax liability would be required and the credit could be claimed on top of an EITC credit.

One way to build a nationwide tax-based asset-building strategy would be just this sort of refundable credit provision, which perhaps could be included in any middle-class tax cut legislation. Low-wage workers would be encouraged to elect a percentage to be "saved" via automatic deduction from their EITC refunds. This amount, and the matching credit, would then be directly deposited by the government into a centrally-managed tax-deferred TSP-style fund, or forwarded to the qualified financial service provider designated by the participant. Participants would receive the investment information and counseling they would need; they would make investment allocation choices; and they would receive quarterly statements as their funds grew each year. And unlike the retirement savings credits proposed thus far, these funds would be made available (upon reaching a threshold of $5-$10K, for example), for the purchase of assets including a home, education, or business. This IDA policy option would help to offset the current regressivity of the overall tax burden at the lowest levels.

Again, such a plan could be funded via the long-term savings in social welfare and unemployment programs. In addition, funds made available by closing corporate tax loopholes, or by tapping into the budget surplus, could help finance the program. An alternative 401(k)-style approach that would reward tax credits to employers offering IDA-type benefits to their employees, is also promising (although it may be shunned by smaller employers, just as 401(k)'s often are). Unfortunately, relying solely upon an employer-based tax strategy would suffer two additional disadvantages: 1) many employers would consider it onerous to be saddled with yet another government program to administer for their employees; and, 2) it would not provide universal coverage because not all workers have an employer. Business advocates, in response to President Clinton's $33 billion USA proposal, recommended that, rather than ask the business community to administer a "complex new program" that would involve maintaining individual accounts with separate accounting of employee, company, and any Federally-provided benefits, policymakers should offer savings tax benefits directly to low-income families.[19]

Social Security--Just as a solvency crises led to the privatization and reform of the Federal pension system, a similar crisis threatening Social Security may lead to a similar result. The inclusion of personal asset accounts into the discussions for Social Security reform offers a tremendous opportunity for the asset-building movement.

The crisis in Social Security is driven by demographic projections, which call for an 80% increase in the number of Americans over the age of 65 over the next twenty-five years. Social Security actuaries project that by then there will only be two workers supporting each retiree, as opposed to nearly four workers to each beneficiary today. If the actuaries are right, massive, accruing Social Security and Medicare unfunded liabilities could approach 4.5% of GDP by 2030. The smaller pool of workers, forced to shoulder the burden of the enormous baby boomer generation's Social Security checks and health costs, will be hit hard by tax increases and/or new Federal borrowing to pay for it.

Of course, the actuaries could be wrong. The economy could grow to heights no one today could imagine, or baby boomers might decide to postpone retiring, or put it off altogether. Or a massive new wave of immigrant workers could increase the working population enough, thus undercutting SSA projections. (Interestingly, Census Bureau projections contradict SSA's. The Bureau predicts increased immigration--up to 13% of the population by 2050--in part to offset baby boomer retirements). But because the consequences are so dire if the actuaries ARE correct, most people agree that the issue must be resolved sooner, rather than later.

Some of the politicians' new-found interest in discussing changes to the "untouchable" third rail of American politics can be attributed to polling data. An April 1999 GOP poll found that 79% of voters favored individual control over investing a portion of their Social Security payroll taxes into personal retirement accounts. Even 55% of those over the age of 65 liked the idea.

The Bush administration backs Social Security reforms that would employ individual accounts and some form of private market investment to help address the solvency issue. Whether private accounts will succeed or fail will probably come down to the issue of perceived risk. Tying old-age security to volatile market returns is a "risky scheme" for those who believe that the "safety" in a long-term "buy and hold" strategy is flawed. While historical averages (7.8% after inflation from 1926-1998 for the S&P 500, for example) look good, what about the investor who happened to invest his life savings in 1968 and withdrew them in 1982, only to have less money (after inflation) than when he started?[20]

Furthermore, these critics might add, if <u>everyone</u> has a piece of the market, won't they only be artificially driving up the prices of corporate equities, making them even <u>more</u> risky? Inevitably, they say, the bubble will break, and the market will come crashing down to "fair value." These skeptics support their position by the historic tendency of markets to "revert to their mean." Thus, the recent decline in stock market returns is simply a market "reversion" to fair value after a prolonged period of nearly double long-term secular yields. In this view, below-average returns will dominate for an extended period, now, in order to maintain the long-run, historical averages.

But the critics' favorite argument for NOT investing participant-directed Social Security accounts in the private sector may be the Long-Term Capital Management (LTCM) debacle. LTCM was a hedge fund operated by sophisticated investment professionals. The fund regularly returned 40% on annualized basis. The Fund relied on asset diversification techniques, primarily, to manage risk. The strategy failed when in one month it lost 90% of its capital. LTCM, were it not for a government-engineered bail-out, might have taken the entire stock market down with it.

Such concerns lead the critics to question whether investing Social Security taxes in private capital markets would necessarily yield higher returns than the Social Security Trust Fund is currently earning from the US Treasury. On the other side of the argument, proponents of private Social Security investment accounts, (many of them "New Economy" contrarians), point out that "risky" hedge funds would never be a "prudent" repository for the bulk of anyone's retirement funds. LTCM's managers took huge risks to achieve their stellar returns. The strategy failed because they over-leveraged themselves, staking massive positions in relatively illiquid assets (junk bonds and Danish mortgages, for example). When Russia defaulted on its debt, and investors began bailing out of the market, LTCM managers were unable to unwind certain positions to curtail their losses.[21]

"New Economy" market optimists no longer see historical norms as particularly relevant. The extraordinary gains in productivity over the last decade, they say, have lead to higher functional levels economy-wide that are here to stay. In particular, these critics point out, the risks of stock market investing may be overstated, given the strong historic performance of the American market and the success of <u>passive</u> investment strategies, in particular. Many experts question whether passive investments deserve much of any risk premium at all.

Fundamentally, US stocks are priced by the free market; they reflect what rational investors are willing to pay for company earnings. As earnings rise, stock markets rise. As earnings fall, so do markets. And while no one can predict future market performance, the current "returns" on Social Security ARE predictable. Experts have calculated the return on the average taxpayer's Social Security contributions to be around 2%. Risk-averse investors who would prefer the status quo are essentially betting that the American economy, the most productive in the world, won't grow any faster than that over the long-haul. (Even Communist China is growing at a rate of around 4%). Even the most conservative mix of stocks and bonds yield at least 5% over time. For today's younger workers (NOT those nearing retirement), a market-based return would be a clear improvement over the status quo. And poll data suggests that people understand this, perhaps because so many of them already have their retirement nest eggs invested in the equity markets.

Unfortunately, neither political party appears particularly committed to private account, savings, and asset-building policies as a <u>primary</u> policy mechanism for increasing US savings and investments and boosting the economy. Many Democrats prefer a strategy of paying down the national debt to zero over the next thirteen years with the budget "surpluses". Republicans and the Bush administration prefer giving the surplus back via tax cuts (although, again, income tax cuts for low wage earners are of dubious value).

While redirecting the Social Security surplus to pay down the national debt may be good for the bond market, it does little to preserve the integrity of Social Security; when the Medicare and Social Security Trust Funds begin to redeem their assets, the Treasury will reissue every dollar of debt redeemed from the public under the buyback plan. While using the Social Security surplus to pay down the debt will save interest costs on the public debt on the one hand, it will simultaneously be incurring them again (to the Social Security Trust Fund) on the other! In fact, gross Treasury debt would grow from $5.6 trillion at the end of the current fiscal year to $6.8 trillion in 2013 under this strategy.

On the other hand, using the surplus to invest in private Social Security accounts would actually be "saving" those Social Security payroll tax receipts for future benefit financing. Social Security reform presents a once-in-several-lifetimes opportunity for wealth-building policy advocates. Just as a self-directed savings component made sense over a decade ago in updating the Social-Security-like Civil Service pension to better meet the needs of a modern Federal workforce, Social Security could and should be modified to better meet the needs of today's (and future) working Americans at all levels of income.

The Social Security Reform effort, with its payroll withholding mechanisms already in place, would make an ideal vehicle for allowing the poor to build assets (and thus saving society the extraordinarily high costs associated with a large sector of the economy living out their lives in poverty). To help offset the regressive payroll tax at low-wage levels, any privatized Social Security account should be matched, and limited pre-retirement withdrawals should be allowed.

Because of Social Security's pay-as-you-go financing, any privatization of Social Security will be expensive. Just as with FERSA and the TSP, funds to pre-pay new Social Security retirement savings accounts will have to be set aside now and thus will not be available to pay for current benefits. Because of this increased near-term expense, there is great political risk in "broadening" matching benefits beyond the low-income population. The high costs of any such middle-class entitlement add-ons, without offsetting Social Security benefit reductions to pay for them, could jeopardize the chances for establishing the asset-building framework for the working poor.

That said, given the FERSA experience, it may not be wise to take future Social Security benefit reductions off the table, if they would help pay for new savings benefits. Taxing or reducing the Social Security benefit checks of wealthy Americans, could, for example, help pay for benefit enhancements such as an IDA-component for low-earners. The difficulty in financing the "transition" from the old Social Security to a new system makes it critical that reform happens now, while the budget surplus can help pay the transition costs of funding current benefits while at the same time investing the funds that will pay for future benefits. The more that is saved and invested now, the sooner the system will be accrual-financed, as is required by law of all private-sector pension providers.

With full actuarial funding, the "Ponzi"-like financing of dynamic government pension entitlements under static tax and spend schemes will become a thing of the past. Furthermore, self-directed asset accounts, because they belong to individuals, will be "safe" from politicians and bureaucrats "borrowing" them to pay for more immediate budget priorities.

And just as it was in the transition from the "old" Civil Service Retirement System to the "new" FERSA, long phase-in and voluntary conversion provisions will be key components. Current and near-term retirees must be guaranteed current benefit levels. New hires would be automatically covered under the new Plan, and those in the middle would have the option to "cash out" and invest their accrued Social Security benefit under the rules of the new Plan.

And like the Federal pension experience, any Social Security reform effort should be comprehensive, taking a good hard look at optimal program architecture, rather than taking an ostrich-in-the-sand or band-aid approach. What should the program look like to best fit the needs of today's workforce, as well as tomorrow's? If the fundamental mechanism is personal saving today to ensure old-age retirement security tomorrow, then the question becomes—-who better to do the saving? The government? Or the American worker? For most people, the answer is obvious. The Social Security Trust Fund wouldn't be stuffed with IOU's if the government had served in a proper fiduciary capacity, as it requires of all private pension plan managers.

To the degree that personal investment accounts become the backbone of a new Social Security system, (once the program has been fully phased-in), then the defined benefit component of Social Security could become necessary only for those who "fall through the cracks"; those whose savings are insufficient to keep them out of poverty; those who are chronically unemployed, or who are physically or mentally disabled; or those who have somehow lost their savings due to conditions beyond their control. Eventually, the "defined benefit" portion of Social Security would then convert to a "safety-net" benefit comparable in size and nature to the benefits offered today. But most workers could rely comfortably upon their private accounts, including any government and employer matching contributions, their own additional savings, as well as any employer-provided pensions, for the bulk of their retirement security.

The transition over to a new savings and investment-oriented Social Security program, with an asset-building component for the working poor, must happen as part of deliberate reform effort begun today, rather than as a system response to a funding crisis twenty years from now. If it does not, means-testing will happen, anyway, because of the unacceptable tax burden that will fall upon future generations.

CONCLUSION

In the traditional world of pensions, retirement security was said to rest on a three-legged stool of Social Security, employer-provided retirement benefits, and personal savings. But today's world looks very different. Too many people have neither savings nor assets. Employer-provided defined benefit pensions are disappearing. Defined contribution plans are not universally offered by all employers; and, temporary, part-time, and contract workers earn no company pension benefits. Without the assets provided by two legs of the stool, Social Security has become the only thing between a third of its recipients and poverty.

Now, Social Security is also threatened. Young workers perceive that Social Security, while sustaining their grandparents, will not be there for them. Changes must be made now in recognition of both this new reality, and the changing world of work.

For the new high-tech information age worker, numerous job and career changes will become a fact of working life. A new workforce culture centered around the individual is emerging to supercede old hierarchal and social structures. Productivity, and not the rigid rules of the past, will become key to both personal and institutional advancement. Stock options, profit sharing, and incentive-based pay are already beginning to replace earlier forms of compensation, even for union workers.[22] The communal, practical orientation of the 20th century, centered within mass production, big business, big labor, and big government is becoming obsolete in the face of increasingly empowered individuals and a globally competitive, information-based world.

Throughout history, political realignments follow fundamental economic change. In the next century, a "New Polity" will likely emerge. It will be centered around an ethic of personal choice and shared risk. It will harness the forces of entrepreneurial self-interest and market capitalism. It will characterized by a smaller, more flexible, decentralized, responsive, and accountable government.[23]

As information technologies increasingly empower individual access to information, work and lifestyle changes follow, and political winds shift. Both Republicans and Democrats, it seems, are beginning to ascribe to the idea that government programs should be retooled to augment the capacity of the individual to control one's life.

Just as the capital accumulation movement shifted the responsibility for retirement security from corporations to individuals; the asset building movement will shift government efforts to eradicate poverty to the level of the engaged participant. Asset-builders have a number of natural allies in their efforts to grow a national agenda. Allied reform constituencies include those attempting to redress imbalances in the areas of: earnings and wealth gaps, negative US savings rates, social welfare reforms, and tax, and pension (including Social Security) reforms. The extemporaneous confluence of these agendas couldn't be more fortuitous. All of these factors suggest that individual, participant-centric policies, asset-building, and low-wage savings and investment accounts are a matter of not "if" but "when" and "how".

Asset-builders can learn much from the successful creation and experience of the world's largest savings program, the Thrift Savings Plan. **Poor people WILL save**, but the government must make it easier for them to do so. According to Bureau of Labor statistics, US households don't even begin to save until household income reaches $40,000 per year. The working poor will need matching contributions as well as financial literacy information and personal assistance if they are to achieve their goals. If we can afford to subsidize expensive mortgage and pension tax deductions for the middle and upper classes, surely we can afford to offer a comparable benefit to our neediest citizens.

There are a number of disparate approaches policy makers could take to achieve the establishment of a national-scale asset-building initiative. We could modify (or offset) odious payroll and sales taxes. We could divert welfare dollars to this effort. We could offer a refundable tax credit "match" to EITC recipients who choose to "save" a percentage of their tax refund, by depositing both their election and the match into a tax-deferred TSP-style account. We could incorporate low-income asset-building policy into Social Security privatization.

Financing a universal asset-building system for low income Americans will require a new, earmarked revenue stream. The budget surplus can help **fund** such a plan, as could State TANF surpluses. Investing today in a national asset-building plan will pay off in the near-term by infusing new savings and investments into the economy. In the medium term, cost reductions in other social service programs will help foot the bill. And, in the long run, as whole new generations move into the middle and upper classes, new tax revenues will pay yet again for any investments made today.

Personal asset accumulation accounts, either in conjunction with a refundable EITC credit, Social Security privatization, or separately, may call for **central government administration**, under the condition of rigorous fiduciary accountability and independent governance. Existing Social Security and EITC administrative infrastructure may make this the logical approach. On the other hand, asset accounts for low income savers who are also either current or former clients of the social welfare system, could be serviced via "retail" social service offices. Accounts created via private employers, the tax code or through existing IRA or 401(k) mechanisms might best operate on a **decentralized** basis, with qualified financial service providers competing for IDA business. Alternatively, like the TSP, a combination model might rely on local private service providers for retail-level activities, while account and investment management could be administered centrally. A government-managed "default" investment plan might be beneficial, along with investment choices tailored to the needs of long and short-term investors

The problem of limiting **government influence in the private marketplace** can be resolved, as the TSP has shown, through well-designed governance and investment policies. The decision to invest passively, in index funds, instead of actively picking stocks not only helps mitigate risk (by replicating the return of the entire market rather than individual companies), but also helps ensure there will be no government interference in US private enterprise.

Investment risk can be managed, as it is with private insurers, by "the law of large numbers"--managing lots of small risks by pooling individual exposures in large portfolios. Among the ways the TSP has been able to reduce market risk and optimize returns is the popular G-Fund, which, as currently managed, guarantees a return that exceeds inflation. In addition, market risk can be reduced via passive investment strategies such as low-fee index funds, which outperform most actively managed funds in most years. High management, trading fees, and taxes make it almost impossible for individual stock-pickers or actively managed stock funds to beat or even match market returns over time.

The Cash Balance approach, which provides a minimum threshold of return, and the Rail Road Retirement Board plan to return excess contributions to employees and likewise raise contribution taxes in the event of poor investment returns, are alternative strategies for ameliorating risk-oriented concerns about investing in America's capital markets.

In terms of Return On Investment (ROI), random stock selections off the Shanghai/Shenzhen exchanges could best the American worker's 2%-return-on-Social Security status quo. And while the outlook for the Chinese economy might be uncertain, the long-term outlook for American capitalism couldn't be brighter. High tech American business innovations including Build-to-Order systems and Vendor-Managed- Inventory technologies are only beginning to come on-line. Over the long run, productivity gains will continue to be achieved as businesses are able to cut inventory management and other operating costs, access consumers directly, and become even more responsive to their customers.

Americans, through their 401(k) plans and IRA's have already become accustomed to investing in the capitalist marketplace. And while there are short-term fluctuations in market-based returns, younger Americans, if given the option, would be better off taking their chances on the American economy than settling for the 2% currently offered (and likely rescinded) by Uncle Sam.

Three policy vehicles currently offer the greatest potential for the successful consummation of the asset-building agenda: social welfare reform, tax reform, and Social Security reform. It is now widely recognized that traditional social welfare approaches involving centrally-planned government prescriptions for ensuring equality, equal opportunity, and a decent living standard for all, have failed to live up to their once vaunted promise. The forces of individual initiative and the private marketplace must be corralled into service if this societal objective is ever to be achieved. The role of government must shift from that of social engineer and bureaucratic administrator to that of senior facilitator, ensuring fiscal accountability, equal opportunity and access, and compliance with established rules and responsibilities.

The unwieldy budget-busting social welfare bureaucracies of the 20th century will likely become a thing of the past in the 21st. A bi-partisan effort to revamp entitlement programs along the lines of participant choice and empowerment balances Republican goals for individual freedom and a smaller, less intrusive government with Democratic objectives prioritizing equality and communal welfare.

Social Welfare, tax, and pension policy in the 21st Century will rely less on **externally**-imposed redistribution strategies. Instead, the objective will be **inclusive** access to the dynamos of capitalist growth--education, capital, and physical resources. And the <u>inclusion</u> of a currently disenfranchised population into the world of the “investor class” will not diminish anyone else’s share of the “pie.” Even as more investors enter the market, the “pie” will expand as the fruits of new productive capital benefit all.

Whether a universal wealth-building policy is rolled up in social services reforms, tax strategies, or Social Security reform is not as important as that it happen now, while our economy is strong and our government is in surplus. A universal asset-building initiative will simultaneously help ameliorate the extreme pressure of the regressive payroll tax at the lowest income levels, and improve US savings rates. It will also begin the long process of narrowing wealth and earnings differentials. Low-wage asset-building participants will suddenly find themselves active owners and stakeholders of the American Dream. Their work, even in the most menial of jobs, will suddenly take on the dignity and meaning that it never had before. Their efforts will lead to immediate reward, both for themselves, their communities, and their country. Taxpayer burdens would gradually be alleviated as the government is relieved of some of the social costs of poverty. An entire generation freeing itself from poverty virtually assures that subsequent generations will also live free of poverty.

Let it not be said of our generation that we saw a way to move future generations out of poverty, and squandered the opportunity.

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