



NEW AMERICA
FOUNDATION

**Testimony of
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**The President's Commission to Strengthen Social Security
October 18, 2001**

**Progressive Privatization:
A Better Way to Reform Social Security**

Good morning members of the Commission. My name is Maya MacGuineas and I am a Fellow at the New America Foundation, a non-partisan think tank in Washington DC, where I work on fiscal policy. Thank you for the opportunity to testify before you today. I realize that most of the country's attention is focused on more immediate threats - as is only appropriate. But it is important that at the same time, we take action to address the longer-term threats we know exist to our nation's retirement program. So I thank you for going forward with the important work of the Commission.

I will focus my remarks not only on why a reformed Social Security system is necessary to provide a secure retirement for younger generations, but also on a few of the details I think are of particular importance in putting together a comprehensive reform package. I will specifically focus on how to make a system of private accounts more progressive.

Strengthening Social Security for Future Generations of Retirees

As members of the Commission, you are quite familiar with the problems facing Social Security. Your Interim Report lays out the problems clearly and accurately and I hope that members of my generation - and all generations - will take the time to read it.

From the impending cash flow deficits, to the dilemma of how to repay the trillions of dollars owed to the trust funds, to the demographic stresses a declining worker-to-retiree ratio present, there are a number of imbalances that will have to be addressed. The sooner they are, the less costly they will be.

At the same time, to view the challenge of reforming Social Security as merely a question of how to get the numbers to add up is to view the problem through too narrow a lens. The need to reform Social Security also presents an opportunity to strengthen the program in ways that will profoundly affect the retirement security of generations to come.

From an individual perspective, Social Security - a program that has been remarkably generous to retirees in the past - now offers participants an increasingly bad deal in terms of what they receive in total retirement, disability and survivors benefits relative to what they contribute in taxes, as well as little flexibility in meeting their personal saving, investment, and retirement needs. If structural changes are not implemented, current workers will be left with only a fraction of their promised benefits, or they and their children will be saddled with dramatically higher tax rates. Under the current system there is no way around these choices. As for their grandchildren, the condition of the system will be even worse. From an economic perspective, the pay-as-you-go structure offers little benefit to the economy and probably harms it by contributing to languishing saving rates.¹ And from a budgetary perspective, the mounting costs of the program are squeezing out other important areas of the budget and have already created a budget far more skewed towards consumption than investment.

Increasing Saving

As the Commission has rightly pointed out, the single most important step in strengthening Social Security will be to boost national saving. Higher saving rates channel more money into productive investment, creating higher economic output and wages. A larger economic pie, in turn, will reduce the burden of paying for mounting retirement costs.

Given that most experts agree we need to increase saving, I believe the two most contentious areas of debate will be who should own the savings - the government or individuals - and how we should pay for it.

Theoretically, a plan to increase saving need not incorporate personal accounts; the government could increase its contribution to national saving by running larger surpluses, paying down the debt and, over time, acquiring private assets. Practically, however, this approach presents serious problems. First, there is an important distinction between prefunding the Social Security program on paper and actually setting aside the resources to cover future benefits. As we have seen over the past two decades, politicians are far better at spending surpluses than saving them. Given the continued pressure on our representatives to enact spending increases and tax cuts when surpluses exist - even when those surpluses belong to Social Security -- it is highly unlikely that the Social Security trust fund structure can ensure sustained levels of greater saving. And frankly, that is not a gamble we should make with money that is supposed to be set aside for retirement.

¹ In a 1997 survey, economists responded that the current Social Security system reduces the personal saving rate by an average of 3 percentage points.

Secondly, if a plan for the government to save future surpluses were successful, or the trust fund investment policy were altered so that a portion of the funds were invested in private equities, such changes would present a host of new problems. You have heard testimony on this topic in prior meetings, so I will not go into detail. Suffice it to say that the risks posed from the government owning trillions of dollars of private equities, from the pressures to make “socially responsible investments” – with there being as many definitions of “responsible” as there are politicians, to how proxies would be voted, to the liquidity constraints involved in investing a single massive fund -- make government investment quite risky.

The Multiple Benefits of Private Investment Accounts

The better option is to do the saving privately by allowing individuals rather than the government to own the savings, thereby walling off the money from other spending - the only truly effective way to lock away Social Security funds.

Private investment accounts have many other advantages as well. Shifting a portion of the program from a defined benefit to a defined contribution structure will alter it from a purely consumption/transfer program to a saving/investment program. The program will be better insulated against the baby booms and busts to which our pay-as-you-go system is currently vulnerable. Social Security will no longer be dependent on ongoing tax increases and benefit reduction to remain balanced. Once the transition is completed, returns for participants will improve, something that cannot otherwise be expected to occur. A prefunded diversified system will, over time, be able to either operate on lower contribution levels or provide higher retirement benefits. Avoiding the quagmire of government investment will also have the advantage of modernizing Social Security’s “one-size-fits-all” approach, replacing it with a more flexible system to accommodate differing work, saving and retirement needs. Finally, the fifty percent of workers who have little or no savings and have routinely been shut out from the economic gains that come from capital ownership will be included in the asset-owning class.

“Progressive Privatization”

There are three concerns regarding private accounts that I believe are valid. The first two, higher administrative costs and investment risk, can and should be addressed through prudent regulation. The third has to do with the progressivity of the system. Some critics of private accounts are concerned that implementing investment accounts would reduce an important redistributive element of the current system.

I am submitting with my testimony the details of a reform package I call “Progressive Privatization.” The proposal includes a structure whereby the system would be made *more* progressive through government matches for the contributions of lower-income workers. Matches would be provided not only for voluntary contributions, to create an incentive for additional saving by lower-income workers, but, recognizing that many workers at the lower end of the income spectrum are already stretched to the limit and can just plain not afford to save, it would provide government matches for the mandatory saving coming

from existing payroll taxes as well. My plan includes progressive matches ranging from 2-to-1 to 1/3-to-1, depending on income levels. The specifics of the matches and income cutoffs can obviously be altered to make the accounts more or less progressive.

Progressive personal accounts are desirable for the following reasons:

1. Wealth building: By allowing lower-income workers to invest a greater portion of their wages, progressive accounts build wealth fastest among those who need it the most.

2. Administrative costs: Progressive accounts will ensure that each account is of sufficient size to be administered efficiently, resolving the problem of high administrative costs eating away at small account balances.

3. Annuities: Depending on how annuities are structured, large accounts will reduce adverse selection problems, which are exacerbated by the fact that the longest-living individuals have larger savings and purchase larger annuities. If each individual account were closer in size, adverse selection would be reduced and annuities would be available at lower cost.

4. Public confidence: Questions are now being raised about whether Social Security effectively aids the least advantaged in society. By making the personal accounts progressive, the public will clearly understand that Social Security, and personal investment accounts, can aid lower income Americans.

5. National saving: The most important reason to fund accounts progressively is to ensure increases in national saving. If accounts were funded as a straight percentage of wages, then high-wage workers would have proportionately larger accounts balances than would low-wage individuals. But, high-wage individuals are likely to reduce saving in their non-Social Security accounts in response to new contributions to their Social Security account, offsetting much of the increase in national saving. Low-income workers, by contrast, have no non-Social Security savings to offset, and so contributions to their accounts would constitute full increases in national saving. Personal accounts weighted toward low-income workers may be the most economically efficient, as well as the most progressive, reform option.

Though private investment accounts will over time provide a new source of funds that will help fill in the Social Security funding gap and Progressive Privatization will maintain important redistributive elements of the system, private accounts alone are not a magic bullet. Fixing a program facing tens of trillions of dollars in deficits will not be painless and other measures will be necessary in the interim as the accounts have time to grow. We will have to come up with the money to save in workers' accounts while continuing to pay for existing benefits. It is an economic reality that we cannot save more without consuming less.

The “pain” of increased saving should not be an excuse to defer the creation of personal accounts and resort to band-aid solutions instead. It is difficult to muster the political courage to make the decisions that bestow benefits beyond the next political cycle, but retirement entails long term planning and our leaders must make responsible choices. The creation of these accounts will dramatically reduce the cost of funding Social Security in the future. Private accounts should be viewed as what they are: an investment, one with upfront costs that are clearly worthwhile given their longer-term benefits - both to individuals and the economy.

There will certainly be disagreement about the combination of spending reductions, tax increases and/or general revenues that should be used to fill in the funding gap to balance the system. A mix of these policy changes will be needed whether or not private accounts are integrated into the system. I find it somewhat irresponsible when advocates of one approach or another weigh in on what we should not do without including what they actually would do to fix Social Security. They know that Social Security will start running cash flow deficits in 2016. They know the money that was intended to be saved for Social Security was spent on other government programs and that repaying the trust funds will be just as burdensome as if the Social Security trust fund had never existed. And they know that plans that focus merely on achieving “actuarial balance” quickly fall out of balance in later years, creating the need to “reform” Social Security all over again. I believe it is therefore an imperative for those who object to certain approaches to offer realistic alternatives.

The Progressive Privatization plan I am submitting includes details of how to pay for all aspects of keeping Social Security balanced. In addition to creating private investment accounts, the plan relies on a package of changes structured to:

- 1) Spread the costs fairly between individuals and generations;
- 2) Protect the benefits of recipients who rely on them;
- 3) Complement the new system of private accounts; and
- 4) Benefit the economy.

The mix I propose includes a combination of spending reductions and revenue increases, which I am happy to explore as time permits. Let me point out one thing I think is of particular importance: Progressive Privatization does not rely on government borrowing to keep Social Security’s revenues and expenditures aligned. Given that one of the most important advantages of prefunding the program is the positive effect it will have on national saving, borrowing to create investment accounts would severely undermine those economic benefits. Therefore, I think it is important that we be willing to make the changes necessary to keep Social Security balanced now rather than shifting the costs to the future.

And that is what this task is really about; shoring up the system for the future. Our elected representatives cannot afford to disregard the mounting costs and unfunded liabilities of the Social Security program. To do so would be to ignore the effects of those costs on the rest of the government, the economy and future generations.

Private accounts - if structured to meet their full potential - can provide more revenues by increasing saving and more appropriately balancing investments. Through a form of Progressive Privatization, the Social Security system can be made progressive enough that all workers can afford to retire with dignity and at the same time fair enough that all who participate will receive adequate returns on what they contribute. This is the legacy we should leave to the next generation of retirees.

I appreciate the chance to appear before you today and I thank you for all the hard work you are doing to strengthen Social Security for the 21st century.