STRENGTHENING SOCIAL SECURITY

Testimony before
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Chairman Moynihan, Chairman Parsons, and members of the Commission, thank you for the opportunity to appear before you today to discuss ways to strengthen Social Security. I would like to use my time to argue strongly against cutting back on Social Security's defined benefit promises and replacing them with individual accounts. Individual accounts will not solve Social Security's long-run financing problem, and they are unduly risky for people's basic retirement benefit. Substituting this risky alternative for Social Security's defined benefit is the key issue in this debate.

Let me clarify what I am not arguing about:

- I am not here to debate the merits of prefunding Social Security's commitments. I think using the Social Security system to increase national saving is a good idea. It will provide more national income in the future, which will alleviate some of the burden of supporting an aging population. It will also reduce the high pay-as-you-go tax rates scheduled under current law. So accumulating reserves is a desirable step.
- Similarly, I am not here to dispute the merits of broadening the investment portfolio to include equities. I would like to see Social Security participants – particularly those with no other assets – have access to higher returns.
- I am not here even to argue against individual accounts. Once you have restored balance to Social Security to preserve most of today's pension promises, supplemental accounts through Social Security would be an easy and efficient way for people to add to their saving.

I am here to urge you to adopt the following guidelines as you put together your recommendations:

- Restore 75-year balance to Social Security, so that people can regain confidence in the system.
- Retain the program's defined benefit structure, so that retirees will have predictable retirement income.
- Consider any individual accounts provision as an "add on" not a "carve out" from the existing program.

Let me take a minute to elaborate on each of these points.

I. Restore 75-year Solvency to Social Security

The most important thing you can do is to restore balance to the Social Security program for the next 75 years. This program is crucial to the economic well being of older Americans, and constant debate about its viability hurts the people you want to protect.

Over the next 75 years, the Social Security Trustees project that benefit payments will amount to 15.44 percent of taxable payroll and revenues to 13.58 percent, which produces the much-publicized deficit of 1.86 percent of taxable payroll. Restoring balance to a system where expenditures are projected to exceed income requires changes in cash flows. The only ways to improve cash flows are to increase revenues, lower benefits, or improve returns on trust fund assets. Notice that the list of options does not include "individual accounts." They are not on the list because, by themselves, individual accounts do nothing to improve cash flows and the financial position of Social Security.

Since individual accounts are no magic bullet, restoring balance will require painful choices. Benefits will have to be cut and/or taxes raised. There is no rule for how much to do of each, but historically both increases in revenues and cuts in benefits have been part of legislation to make Social Security financially sound. For example, in 1983, a commission headed by Alan Greenspan recommended a balanced package of revenue increases and benefit cuts to restore 75-year solvency.

The same approach should be adopted this time, and the list of both benefit and revenue options is extensive. Some steps that are both inherently fair and would cut the long-run deficit include: extending coverage to new full-time state and local government employees (about 3.7 million workers) not now covered by Social Security, making Social Security benefits taxable to the extent they exceed worker contributions (comparable to other contributory defined benefit plans), lengthening the averaging

period for the Social Security benefit calculation, and improving the accuracy of the cost-of-living adjustments as the Bureau of Labor Statistics refines the Consumer Price Index. Many would also argue for an increase in the Social Security maximum earnings base to bring the proportion of earnings subject to tax (currently 86 percent) more in line with the 90-percent figure established in 1983. It is not difficult to identify changes that would close the 75-year financing gap in the Social Security program, but it takes political will to propose a package.

I would argue that investing a portion of the trust fund in equities should be part of any plan to restore balance to the program. By reducing the size of the required benefit cuts and tax increases, equity investment would improve the returns to the system. This proposal has met with opposition from those who fear that it would lead the government to interfere in private sector activities. My view is that such pressures are easy to guard against. Social Security could build on the successful example of the federal Thrift Savings Plan, which provides retirement benefits for federal employees. Congress could set up an independent investment board of financial experts with fiduciary responsibility, and the Board could invest in a broad index, delegate voting rights to fund managers, and finance its own administrative costs so it does not have to rely on Congress to appropriate funds each year. These protections should ensure efficient investing of trust fund reserves in equities.

I am encouraged about the feasibility of Social Security investment in equities not only by the performance of the Thrift Savings Plan but also by that of state and local pension funds, which currently invest about 57 percent of their total assets in stocks. The performance of state and local pension funds is an area where my views have changed enormously over time. Twenty years ago when I was a member of the Massachusetts Retirement Law Commission, a body that oversaw Massachusetts' public pension plans, I would have been skeptical about the ability of government entities to invest funds efficiently. In fact, I wrote an article in the early 1980s documenting that state pension funds sacrificed significant returns in order to engage in so-called social investing. However, the performance of state and local pension funds has improved enormously

over the last 20 years. Some recent research that I did shows that political considerations have had almost no effect on investment decisions at the state and local level, and that today public plans appear to be performing as well as private plans.[1]

Another useful example is Canada. Canada decided to invest its public pension fund in the stock market to increase pension returns, and created the Canada Pension Plan Investment Board in 1997 to oversee those investments. Canada's program is up and running, and the Board has not confronted any serious problems.

The additional revenue from building up a fund in the Social Security program and broadening the investment options to include equities will reduce, but not eliminate, the required benefit cuts and tax increases to restore solvency. In the end, solvency will require more money and/or less benefits. I would argue for a balanced approach, and not put the entire burden on the benefit side.

II. Retain the Defined Benefit Structure

The second guideline that I would urge you to adopt is that, in the process of restoring 75-year balance, you retain Social Security's defined benefit structure. It is possible to have equivalent amounts of funding in the Social Security program and in a system of individual accounts, and equity investment is possible in either scenario. So the question

[1] First, economically targeted investments account for no more than 2.5 percent of total state and local holdings. Although early studies showed plans sacrificing considerable return for targeting their investments to in-state activities, recent survey data reveal no adverse impact on returns as a result of the current small amount of ETI activity. Second, public plans in only three states have seriously engaged in shareholder activism, and this activism appears to have been motivated by a desire to improve the bottom line, not to make a political statement. The literature suggests that this activity has had a negligible to positive impact on returns. Third, the only significant divestiture that has occurred was related to companies doing business in South Africa before 1994. This was a unique situation where worldwide consensus among industrial nations led to a global ban on investment in that country. With respect to tobacco, public plans have generally resisted divestiture, and only a few have actually sold their stock. Finally, state and local governments have borrowed occasionally from their pension funds or reduced their contributions in the wake of budget pressures, but this activity has been restrained by the courts and frequently reversed. See Alicia H. Munnell and Annika Sundén. 2001 "Investment Practices of State and Local Pension Funds" in Olivia S. Mitchell and Edwin C. Hustead, eds. *Pensions in the Public Sector*. University of Pennsylvania Press)

comes down to whether a defined benefit or defined contribution arrangement is better for people's basic retirement income.

Here the economics are clear. Social Security's defined benefit plan, particularly with some prefunding and investment in equities, is better than individual accounts for providing the basic retirement pension. Because Social Security is a defined benefit plan, it can spread risks across the population and over generations. This means that people's basic benefits do not depend on what stocks they pick or when they buy and sell. They are assured a predictable basic retirement income, an amount they can count on.

Retirement income that depends on one's skills as an investor is not consistent with the goals of a mandatory Social Security program. Remember that Social Security is the major source of income for two-thirds of the 65-and-over population and virtually the only source for the poorest 30 percent. The dollar amounts are not very large: the benefit for a worker with a history of average wages who retired at age 62 in January 2001 was $892 per month or $10,704 per year. I do not think that it makes sense to put this dollar amount at risk.

Retaining a defined benefit structure and pooling investments in the Social Security trust funds also keeps reporting and transaction costs lower than creating 150 million individual accounts, ensuring higher net returns to participants. Social Security's pooled defined benefit approach also avoids the pressure for individuals to gain early access to their accounts, insuring that retirees have inadequate retirement income. Social Security's defined benefit approach also assures that accumulated funds are transformed into inflation-indexed annuities so that retirees do not outlive their retirement resources. Finally, a defined benefit structure allows for the provision of dependents' benefits that protect dependent spouses after the worker dies.

III. Consider Supplementary Individual Accounts as "Add On's"

Advocating a defined benefit program for the basic retirement benefit does not rule out a role for individual accounts. Once balance is restored to the existing program, it is possible to consider changes that would improve the likelihood that future retirees will have adequate incomes. One option is to introduce voluntary supplemental individual accounts within Social Security for those who would like to set aside more money. Workers could have their employers deduct an additional 2 or 3 percent from their earnings and forward these amounts to Social Security with their regular payroll tax payments. Individuals could decide to have their additional contributions invested in bonds, equities, or a combination of the two. At retirement, Social Security would pay out accumulated supplementary contributions and the earnings on those contributions either as a lump sum or annuity.

Thus, the debate is not about whether individual accounts are good or bad in general. Once people are assured basic retirement protection, individual accounts may be a perfectly reasonable addition. What opponents of individual accounts object to in the context of Social Security reform is cutting back on existing Social Security benefits and replacing those benefits with a risky and costly alternative. Introducing individual accounts as an *add on* to Social Security is a good idea; substituting individual accounts for existing Social Security benefits is not.

IV. Conclusion

Let me conclude. Most plans being discussed today involve both prefunding and equity investment. In economic terms, the goals of prefunding and broadening the portfolio can be achieved either within the context of Social Security's defined benefit program or in individual accounts. With the possibility of funding and diversifying investments under either scenario, the question becomes which is the best benefit structure for people's basic retirement income. Here the economics are clear. A defined benefit plan allows for better risk spreading, better protection for retirees and dependents, and lower costs than

individual accounts. In short, accumulating reserves is a good idea, investing in equities is a good idea, even individual accounts are a good idea, but not if they involve major reductions in the protections offered through today's Social Security program. We should be talking about adding on savings options, not cutting back on existing benefits.