“Social Security in the 21st Century -- Part 1”

Testimony to the Senate Budget Committee

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Mr. Chairman, Senator Lautenberg, and other honorable members of the Committee, thank you for the opportunity to testify.

All of us are well aware of the looming financial crisis in the Old Age, Survivors, and Disability Insurance (OASDI) program. We are fortunate that the projected cash flows in the system will sustain it for at least the next 30 years. This is our window of opportunity. At the end of that period, every member of the Baby Boom generation will have reached the current normal retirement age. The longer we wait to act, the more severe will be the policy changes that are required to restore solvency to the system and the less flexible will be our policy options.

The most recent Trustees’ Report shows that at the end of its 75 year forecasting period, the cost rate on the OASDI program will rise to over 19 percent under the intermediate assumptions. This cost increase necessitates a pay-as-you-go tax increase of over 6 percentage points from the current level of 12.40 percent if benefit levels are to be maintained. Alternatively, actuarial projections show that over that 75-year period, approximately 2 percentage points of covered payroll per year must be raised in order to cover this shortfall. Further, the last years of that period show the largest deficits. The open-ended actuarial deficit, which extends beyond the 75-year forecast period, is over twice as large.

My remarks today are based on the results of my ongoing research with Professor Martin Feldstein of Harvard University (cited in the references section below). We have designed a simulation model of the OASDI system that allows for prefunding of the program’s future liabilities in a system of personal accounts. All of our demographic and economic assumptions match the intermediate assumptions in the 1998 Trustees Report.

New capital in the system is what will make Social Security’s promises credible. Under our proposal, workers make mandatory contributions to Personal Retirement Accounts, or PRAs. The balances in PRAs are invested in broadly diversified

portfolios of stocks and bonds. As workers reach retirement, PRAs are converted into annuities that replace a portion of their promised OASDI benefits. According to the plan described in my written testimony, OASDI benefits are reduced by 75 cents for each dollar of PRA annuities. Over time, more workers will retire with PRA balances that reflect an entire working career of contributions. As more benefits are paid from PRAs, outflows from the Trust Fund are reduced. With sufficiently large PRA contributions, we can avoid the forecasted increases in the payroll tax rate and potentially increase retirement income levels or provide further payroll tax relief.

What makes this system feasible is that PRA balances are assumed to earn the historical average rate of return on the corporate sector. This return, after inflation, has been approximately 5.5 percent in the postwar period. This figure is net of corporate tax payments and a 0.4 percent allowance for administrative costs but prior to individual tax payments. It is substantially above the implied rate of return on a pay-as-you go system, which is equal to the growth rate of the covered wage base or approximately one percent under the current intermediate assumptions.

Our system of 2 percent PRA contributions generates sufficient balances to stabilize the pay-go tax rate at 12.40 percent while permitting a modest increase in future retirement income. Our primary objective in designing the PRA system was to make only the changes that are necessary to allow for the prefunding of future OASDI liabilities. While arguments can be made for various reductions in the future level of benefits, the public seems to be comfortable with the existing benefit formula. Furthermore, implementing such changes may reduce the size of the additional funding required for PRAs, but they do not necessarily eliminate the need for a new system of PRAs. Whatever the Congress and the President decide for the goals of Social Security in the 21st century, PRAs can help us reach those goals.

The financial details of our plan are laid out in my written testimony. I would like to use the remainder of my spoken testimony to explain some of the institutional details of our plan.

For example, we have described our plan as being “funded out of the budget surplus.” This means that over roughly the next 15 years, the forecasted budget surpluses are sufficient to cover the aggregate PRA contributions. Individuals could

receive a refundable tax credit on their income taxes for their PRA contributions, or the government could simply make the contributions to the PRAs directly.

Such a financing scheme is entirely consistent with the President's public statements to use the budget surpluses to "save Social Security first." But they are not a requirement for the fiscal soundness of the proposal. Using the surplus in this manner simply shifts the financing burden to future generations that might have otherwise had the opportunity for a tax cut. Since the magnitude of the budget surpluses was largely unanticipated, this does not seem like an undue burden. Were it up to me, I would prefer that the surpluses be used for debt reduction and the PRAs financed out of current income. But that is ultimately a decision for policy makers, and we have set forth a plan that, as far as we can ascertain from their public statements, is consistent with their objectives.

Our plan, like all proposals based on individual accounts, raises some other concerns that opponents have been quick to voice. I think such criticisms have been exaggerated. I would like to address these concerns in the remainder of my remarks:

First, administrative costs will be higher under a system of PRAs than a proposal that restored solvency within the current framework. This is a true statement in theory, but one that will not be an insurmountable obstacle in practice. Mutual funds and other investment companies routinely keep administrative costs on passively managed accounts well below 50 basis points. Fixed fees on retirement accounts like IRAs are often waived. And perhaps most importantly, investment companies clearly recognize that successful management of PRAs is the best advertising they could do to attract more of the investors' saving outside of PRAs.

Second, PRAs rely more on individual judgement in the management of their investments to generate retirement income. As a necessary precaution, investment choices will be regulated with straightforward restrictions on permissible investments. To make choices easier, a default plan similar to the Federal Employees Thrift Savings plan can be established for those who do not want to play a major role in choosing their investments.

I would also like to call the Committee's attention to the two-tier system that was succinctly described by Mr. Fred Goldberg in his testimony before this Committee last July. That plan for administration and management of personal accounts

deserves very serious consideration. In particular, having a low cost default plan available to everyone allows the government to reasonably hold individuals accountable for additional charges they might incur by pursuing a more active management strategy or greater customer services than are currently provided.

Third, there have been some discussions of other individual account plans that would reduce the degree to which retirement benefits are paid out as annuities. As it is constructed, our plan requires annuitization, preferably in the form of variable annuities. Critics often note that there are currently loads in the market for individual annuities that could erode much of the higher value of PRAs. This is unlikely to be the case. First, when annuitization is mandatory, the part of the load that is due to adverse selection based on longevity will disappear. Second, it is easy to design a system in which the Social Security Administration continues to handle the annuitization of the retirement account balances, simply by redistributing PRA balances of individuals who pass away to the accounts of the surviving members of their birth cohorts.

Fourth, it is claimed that a system of PRAs will undo much of the progressivity of the current system. Speaking for my own plan, there is no hidden agenda here, and it is certainly not the case that a system of PRAs is incompatible with progressivity. In some incarnations of the plan, the government is making deposits to the PRAs. It is certainly free to make those deposits in a progressive manner. The government could also put in place a small, redistributive tax on the PRA balances at retirement. The PRA balance is the counterpart to the average indexed monthly earnings under the existing program, on which income redistribution is currently based.

Fifth, it is well known and fully acknowledged that the higher return on stocks and bonds compared to less risky government securities comes at the cost of more variable returns. In our ongoing research, we have simulated the distribution of PRA annuities under the specific plan outlined in my written testimony. The probability that the combination of the pay-as-you-go benefit and PRA annuity is less than the benefits currently promised in the law is about 10 percent. The median benefit is approximately one third higher than that promised under current law.

We have investigated two possible approaches to this problem. The first is to increase the size of PRA

contributions. If contributions were 3 percent rather than 2 percent, the probability of a shortfall would drop to about 2 percent. The second, which we prefer, is to have the government provide a conditional guarantee for the benefits on a pay-as-you-go basis. The corporate tax revenue generated on the capital in the PRAs is usually enough to cover the shortfall in that 10 percent of cases, if it is not being used to fund the PRA contributions. I must stress that these results are quite preliminary. More research on the implications of investing both individual accounts and trust fund balances in stocks and bonds is clearly required.

In summary, the main strengths of our plan as a means to secure the promises of the Social Security system are that:

1) It abides by the President's mandate to "Save Social Security first" and by the recommendations of the majority of the last Advisory Council.

2) It addresses the whole problem, meaning the open-ended actuarial deficit, which is roughly double the long-term 75 year deficit. The payroll tax is stable at 12.4 percent under our plan.

3) It fixes the system without cutting benefits. Fiscal problems in Medicare are sure to involve a reduction in the entitlements of retirees.

4) It establishes a system of individual accounts that allows workers genuine access to capital markets in funding their Social Security benefits.

In conclusion, the main contribution of our research on PRAs is not to identify "2 percent" as some sort of magic number. Policy makers may place different emphasis than we have on issues such as the risk, progressivity, administrative costs, and general equilibrium effects of the PRA system. These considerations may ultimately change the 2 percent contribution to some other number. Instead, what our research adds to the discussion is to show that by prefunding future liabilities in the private capital market, retirement opportunities can be expanded using the roughly the same contributions that would merely stabilize the current system in the absence of substantive reform. We must seize our 30-year window of opportunity to re-establish retirement income security for the generations of workers, including my own, who at the moment, seem to believe that it is lost.

Appendix: The Two Percent Personal Retirement Account Plan

Starting in the year 2000, contributions are made on behalf of every worker who is covered by Social Security. As shown in Table 1, this starts out at $70 billion in constant 1998 dollars and grows to over $150 billion by 2070. PRAs are invested in broadly diversified portfolios of stocks and bonds. Beginning the following year, workers who retire do so with both entitlements under OASDI and PRA balances. The PRA balance is annuitized, and 75 percent of it is allocated to the OASDI Trust Fund. The retiree keeps the remaining 25 percent. For example, if monthly benefits under current law are $1000 and the PRA annuity is $600, then the individual gets $550 from the government and has a total of $1150.

Over time, withdrawals from PRAs grow from about $5 billion in 2010 to over $700 billion in 2070. This latter figure represents 9.34 percent of covered payroll. Three-fourths of this amount, or 7.01 percent of covered payroll, is enough to cover the forecasted difference between the 12.40 payroll tax rate and the cost rate (net of the income taxation of benefits) in that year. The last column of Table 1 shows that the Trust Fund never goes bankrupt under this plan. In order to achieve this, all corporate tax revenues from the PRA balances (discussed below) are rebated to the Trust Fund until 2014. Rebates of the corporate tax revenue for additional years (for example, through 2020) could easily be used to maintain the Trust Fund at higher levels.

The new capital required to establish and fund the PRAs must necessarily come from reduced consumption, either personal or public. Because covered payroll is approximately 40 percent of GDP, the 2 percent PRA contributions represent 0.8 percentage points of GDP. As many policy makers have noted, the budget surpluses that are forecast for the next fifteen years exceed this number. Under the assumption that these revenues would have been spent on consumption goods or tax relief that would have been disproportionately consumed rather than saved, then PRA contributions funded out of the surpluses will represent additions to the capital stock. Logistically, workers and employers could make the contributions and receive a refundable, dollar-for-dollar tax credit on their income taxes. Administrative costs can be kept low by using already established Social Security and income tax reporting procedures.

Table 2 shows that after 30 years, PRA assets will be about 37 percent of GDP. Using the historical rate of return on the corporate sector (including corporate tax payments) of 8.5 percent, returns to this capital will generate an additional 3.19 percent of GDP. Assuming that the federal government will be able to tax 25 percent of these additional corporate profits (as it has historically), the corporate income tax receipts will be approximately 0.8 percent of GDP higher than in the absence of the PRAs. The PRA system becomes self-financing after 2030, around the time when the OASDI system would enter bankruptcy if no reforms were undertaken. On average, the system of PRAs would require additional and as yet unspecified sources of financing only from the end of the current budget surpluses through the year 2030.

Table 1
Effects of PRA Deposits and Annuities on Social Security Outlays

Year	PRA Deposits (1)	PRA Annuities (2)	PRA Annuities (3)	SS Outlay Reductions (4)	SS Trust Fund (5)
2000	70.56	0.00	0.00	0.00	25.51
2010	81.92	5.10	0.12	0.09	44.59
2020	92.22	35.54	0.77	0.58	50.41
2030	101.55	112.27	2.21	1.66	31.40
2040	113.62	237.40	4.18	3.13	7.59
2050	125.75	418.50	6.66	4.99	0.30
2060	138.46	600.06	8.67	6.50	6.53
2070	152.70	713.38	9.34	7.01	16.25

Notes:
1) These figures correspond to Feldstein and Samwick (1998a), Table 1, updated to the 1998 Trustees' Report.

2) Columns (1) and (2) are reported in billions of dollars at the 1998 price level.

3) Columns (3), (4), and (5) are reported as a percentage of Social Security taxable payroll.

Table 2
PRA Assets, Increases in GDP, and Corporate Tax Revenue

Year	PRA Assets		GDP Increase		Corporate Tax Increase	
	(1)	(2)	(3)	(4)	(5)	(6)
2010	1077.98	10.42	91.63	0.89	22.91	0.22
2020	2731.15	23.09	232.15	1.96	58.04	0.49
2030	4981.26	37.51	423.41	3.19	105.85	0.80
2040	7547.59	49.83	641.55	4.24	160.39	1.06
2050	10036.66	58.72	853.12	4.99	213.28	1.25
2060	11932.18	62.20	1014.24	5.29	253.56	1.32
2070	13273.00	61.55	1128.21	5.23	282.05	1.31

Notes:
1) These figures correspond to Feldstein and Samwick (1998a), Table 2, updated to the 1998 Trustees' Report.

2) Columns (1), (3) and (5) are reported in billions of dollars at the 1998 price level.

3) Columns (2), (4), and (6) are reported as a percentage of Gross Domestic Product.

4) GDP Increases are equal to 8.5 percent of the PRA assets.

5) Corporate Tax Increases are equal to 25 percent of the GDP increases.

Bibliography of Papers Based on the PRA Plan

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