Statement for the

U.S. Senate Special Committee on Aging

Hearing on:

Strengthening Social Security: What Can Personal Retirement Accounts Do For Low-Income Workers?

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by

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Chairman Craig, Senator Breaux, and members of the Committee. I am Jeffrey Brown, Assistant Professor of Finance at the University of Illinois College of Business.[1] I thank you for the opportunity to appear before you today to discuss the important issue of Social Security reform and its potential effect on the distribution of costs and benefits within the Social Security program.

I would like to begin by summarizing the three main points of my testimony today.

First, Social Security's poor long-term fiscal health requires that the system be reformed in some manner, and virtually any proposal to restore fiscal sustainability will have an effect on the distribution of taxes and benefits across the population. In other words, reform is inevitable, and therefore, the amount of redistribution will also likely change.

Second, any reform, whether it includes personal accounts or whether it relies solely on tax increases or benefit cuts, can be structured to be more progressive, equally progressive, or less progressive than the current system. An important implication of this fact is that it is possible to create a system of personal accounts within Social Security that leaves the system as progressive, or even more progressive, than it is today.

Third, Model 2 of the President's Commission to Strengthen Social Security is a specific example of a plan that can achieve the twin goals of restoring permanent fiscal sustainability and providing a strong safety net for low-income individuals and families.

[1] I am also a Faculty Research Fellow with the National Bureau of Economic Research. During 2001 and 2002, I served on the staff of the President's Commission to Strengthen Social Security and also served as Senior Economist with the President's Council of Economic Advisers.

Background

Ever since Social Security's inception in the midst of the Great Depression over six decades ago, policymakers have attempted to balance multiple, and sometimes competing, goals for the system. Of these many competing objectives, two stand out as particularly relevant for our conversation today.

1. Adequacy: Social Security was designed to provide a floor of protection for lower income individuals and thus reduce poverty among elderly Americans. This generally entails redistribution from higher to lower earners.

2. Equity: Social Security is not a welfare program. It was designed to provide all participants with benefits that increase as their lifetime contributions increase. In other words, Social Security is meant to provide a "fair deal" for its participants.

While there have been many changes to the Social Security system over the years, including dramatic expansions in coverage and large increases in both taxes and benefits, today we still face the same balancing act between these two objectives of providing a "safety net" for the poorest among us and a "fair deal" for all other participants.

Social Security's Financial Status

Meeting multiple objectives with a single program is always difficult, even more so when the resources to finance the program are insufficient over the long run. Indeed, it is in some sense meaningless to discuss the extent of redistribution within the Social Security program independently from a discussion of how the system will be brought back into long run fiscal balance.

It is well known that the current Social Security system faces quite severe long-run deficits that are expected to begin in 2018 and swell rapidly in the years beyond. Indeed, according to the 2004 Social Security's Trustees' Report, the present value of Social Security's benefit obligations exceeds the present value of the program's revenues by

$10.4 trillion, a figure that is roughly comparable to the annual Gross Domestic Product of the United States.

To put these numbers into perspective, by the time my infant son reaches his Normal Retirement Age in the year 2070, taxes would have to be 45 percent higher than they are today, or benefits 29 percent lower than they are currently scheduled, in order for the system to self-finance itself during that year.

As such, it is extremely important when comparing reform options to a baseline to ensure that the baseline is itself fiscally sustainable. For example, a baseline that assumes an immediate payroll tax increase equivalent to the size of the 75-year actuarial deficit will be solvent – but unsustainable – because it ignores the large deficits in years 76 and beyond. In cases in which the baseline is itself not sustainable, any analysis must recognize that additional revenue or benefit changes would be required in the future.

Once one recognizes that current payroll tax rates are insufficient to pay for currently scheduled benefits, it becomes obvious that something must change. To be specific, Congress must either increase the revenues flowing into the system, or it must decrease the expenditures from the system.

Each of these approaches can be implemented in many possible ways, but every possible reform option shares the common feature that the way the system is financed or the benefits that individuals receive will be altered. Unless taxes or benefits are changed in a manner that is strictly proportional for everyone, the extent of redistribution of the overall system will change. The important question is how.

Progressivity of the Current Social Security System and Implications for Reform

Up until a few years ago, it was often taken as a matter of faith that Social Security was progressive, meaning that the system transfers resources from higher to lower income individuals. This faith was based on the fact that the Social Security benefit formula is designed to replace a higher fraction of pre-retirement earnings for low earners than for high earners.

Over the past five years, however, several academic studies were independently and nearly simultaneously conducted that called into question the extent to which the current system effectively redistributed income.[2] Using different data sets, different methodologies, and even different definitions of progressivity, multiple research teams all came to strikingly similar conclusions: namely, that there is much less redistribution in the current system than previously assumed.

There are several reasons for these findings. They include:

1. Higher income individuals live longer, on average, than lower income individuals. Therefore, because Social Security is paid as a life-contingent annuity[3], higher income individuals will, on average, receive a higher level of lifetime benefits than will lower income individuals.

2. Social Security's spousal benefits are based on the earnings of the primary worker. Spouses of high earners therefore receive larger spousal benefits regardless of how much they may have contributed to the program. Because the spouses of high earners also tend to live longer than the spouses of low earners, progressivity is further reduced.

3. Much of the apparent redistribution is from higher income to lower income individuals *within the same household*. In other words, many low-income individuals are married to high-income individuals. Income transfers to these

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[2] Alan Gustman and Thomas Steinmeier, "How Effective Is Redistribution under the Social Security Benefit Formula?" *Journal of Public Economics* 82, no. 1 (October, 2001): 1–28; Julia Lynn Coronado, Don Fullerton, and Thomas Glass, "The Progressivity of Social Security," *National Bureau of Economic Research,* March 2000; Jeffrey Liebman, "Redistribution in the Current U.S. Social Security System," in *Distributional Aspects of Investment-based Social Security Reform*, Liebman and Feldstein.
[3] In the case of married individuals, the Social Security annuity can be viewed as a "joint and survivor" annuity because the spousal benefit features continues to pay the surviving spouse. In addition, in special cases, Social Security will provide income to dependent children.

individuals look like redistribution when examined on an individual basis, but not when examined on a household basis.

4. Some workers with low lifetime earnings are really high-income workers who voluntarily chose to exit the formal labor force. Often, these individuals are able to do this precisely because they are married to other high-income individuals. When we count the *potential* earnings of these workers, the current Social Security program's progressivity is further reduced.

One study concludes that only 2.5 percent of total benefits paid out by Social Security are redistributed across income groups.[4] A second study, which finds income-related transfers on the order of 5 to 9 percent of benefits paid, concludes "income-based redistribution in the current Social security is fairly modest compared to the total benefits paid."[5] A third study finds that by some measures, Social Security may even be regressive on a lifetime basis.[6]

Even though these studies focused on the existing Social Security system, the findings are quite relevant to the reform debate for two reasons. First, they suggest that there is not as high a degree of household lifetime income redistribution in the current system as many people believe. This is important because the existing system is often used as a benchmark against which to compare other reform options. As one of the studies states: "adoption of a Social Security scheme with individual accounts designed to be neutral with regard to redistribution would make much less difference to the distribution of Social Security benefits and taxes among families with different earnings capacities than is commonly believed."

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[4] Alan Gustman and Thomas Steinmeier, "How Effective Is Redistribution under the Social Security Benefit Formula?" *Journal of Public Economics* 82, no. 1 (October, 2001): 1–28.
[5] Jeffrey Liebman, "Redistribution in the Current U.S. Social Security System," in Martin Feldstein and Jeffrey Liebman, eds, *Distributional Aspects of Investment-based Social Security Reform*.
[6] Julia Lynn Coronado, Don Fullerton, and Thomas Glass, "The Progressivity of Social Security," *National Bureau of Economic Research,* March 2000

Second, these studies underscore the importance of analyzing the distributional implications of various reform options from a lifetime, household perspective. It is not sufficient to simply compare a single hypothetical worker at a single point in time under alternative reform plans. To fully understand the distributional implications, one must consider how family structure, mortality-earnings correlations, and other related factors interact with the specific provisions of any reform plan.

Analyses of Social Security reform proposals using microsimulation models, such as that released today by the GAO, have the potential to present a much richer view of both the current Social Security program and alternatives designed to restore it to sustainable solvency. In addition to the GAO, both the Social Security Administration and the Congressional Budget Office now have micro-simulation models that are capable of producing distributional analyses of reform proposals. As such, each of these organizations is now in a position to make valuable contributions to the study and design of Social Security reform options.

Social Security Reform and Progressivity: The Case of PCSSS Model 2

The GAO report underscores a very basic but extremely important point about Social Security reform and progressivity: <u>it is possible to design a fiscally sustainable and redistributive Social Security system that includes personal accounts.</u> Indeed, properly structured, the accounts themselves can be used to increase the degree of progressivity.

This is an important point because it is sometimes assumed that a shift away from the current, pay-as-you-go defined benefit system to a sustainable system that includes personal accounts will somehow hurt the poor. More careful analysis shows that such an assumption is simply false.

Indeed, the President's Commission made a very conscious effort to provide strong protections for lower income workers when designing Model 2. There are several features worth highlighting:

- The personal accounts in Model 2 are themselves progressive, allowing relatively larger contributions by workers with lower earnings. While all personal account participants would expect to benefit from holding accounts under Model 2, lower earning workers would expect to benefit the most because they are able to contribute a higher fraction of their earnings to the account.[7]

- Within the defined benefit portion of Model 2, benefits for low-wage workers would be increased to provide protection against poverty at retirement. Specifically, benefits for minimum wage workers with at least 30 years of labor force attachment would be increased to 120 percent of the poverty line. This is a form of anti-poverty protection that does not exist today, and can mean a significant benefit increase for workers who qualify.

- In fact, the inflation adjusted benefit expected by a low-wage worker in 2052 (the year in which the 1985 birth cohort reaches the Normal Retirement Age) would be approximately 44 percent higher than the benefit received by today's retiree with a low-wage work history.[8]

- Model 2 also increases the benefit paid to low income widows or widowers upon the death of their spouse. Specifically, all aged surviving spouses would receive 75 percent of the benefit that would be received by the couple if both were still alive.[9]

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[7] The offset arrangement in Model 2 uses a 2% offset interest rate, which is lower than the 3% Trust Fund interest rate assumed by OACT. Therefore, an individual participating in the personal account option will have a higher expected benefit than a person who chooses not to participate, even if they invest in a very conservative portfolio. As a result, lower income individuals benefit from the fact that they are able to redirect a larger fraction of their payroll taxes into the account.

[8] According to the January 31, 2002 OACT Memo "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," the expected benefit for a scaled low earner in 2052 is $1,032. In 2004, the benefit for a scaled low earner in 2004 is $719.

[9] This benefit provision is limited to what the survivor would have received as a retired worker beneficiary with a PIA equal to the average PIA of all retired worker beneficiaries in the year prior to becoming eligible for this option. For more details, see the January 31, 2002 OACT Memo "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security" page 6.

- In addition to this benefit enhancement, surviving spouses would also inherit the remaining account balance. Because low-income workers have, on average, higher mortality rates than higher income workers, this inheritability feature may be quite important. Together, these provisions provide substantial protections to low-income widows and widowers.

The result of these features is that Model 2 compares quite favorably to current law in terms of overall progressivity.

The Interaction of Redistribution and Overall Program Resources

One of the most important features of PCSSS Model 2 is that it achieves permanent fiscal sustainability without relying on a permanent increase in payroll taxes or a permanent infusion of general revenue. Importantly, the plan also helps to keep Social Security a "fair deal" for participants by allowing them to invest part of their payroll taxes in personal accounts. The ability to voluntarily redirect part of one's payroll taxes into personal accounts provides workers with a tangible benefit over which they have ownership and control.

Some other reform plans take a very different approach, relying on permanent increases in the tax burden to support a higher level of Social Security benefits. When evaluating these alternative proposals that rely heavily on increased taxation, it is important to ask how that additional money will be spent. If a disproportionate share of those additional dollars is concentrated at the low end of the lifetime household income distribution, then such an approach would increase the progressivity of the system. But in fact, in many of the more expensive reform plans the incremental dollars are being used to increase the generosity of the defined benefit across the entire income distribution. This serves to make the program more expensive, but does very little to help low-income families.

In short, just because a reform plan is more expensive, it is not necessarily more progressive. In essence, if Congress wishes to have a reformed Social Security system that protects the poor, it still has the choice of whether to do so with a very large and expensive system, which would require higher taxes or general revenue transfers to pay higher benefits to high income individuals, or to do so with a smaller system that can, over the long-run, live within the confines of the existing payroll tax schedule while still providing a strong safety net for the lowest income households.

Summary

The Social Security system is an integral part of the retirement landscape in the United States. However, as a result of demographic changes that have rendered the current pay-as-you-go system unsustainable, reform of the system is not only desirable, it is inevitable.

Reforming the system to make it fiscally sustainable requires changes to the tax and benefit structure, and thus changes to the progressivity of the system. By carefully designing a system to target benefits to those households with the lowest lifetime earnings, progressivity can be enhanced as part of any reform effort.

The members of the President's Commission to Strengthen Social Security were very much aware of the redistributive role of Social Security and in Model 2 they designed a plan that restores long term fiscal sustainability while strengthening protections for lowest income households. These protections are carefully targeted to low income workers and spouses, and therefore are able to provide a strong safety net without relying on large and permanent increases in taxation. As such, Model 2 provides a very useful blueprint for how Congress can reform Social Security so that the program lives within its means, while still serving the important redistributive purpose for which the program was intended.

Thank you for the opportunity to speak with you today.