Testimony by Olivia S. Mitchell

I am pleased to appear before this Committee as it hears testimony on social security reforms including the option of investing in private capital markets. In my remarks, I first highlight issues regarding older Americans' retirement income prospects, second I discuss implications for social security investment, and finally I will describe some practical issues that arise in the contemplation of individual accounts.

Americans Retirement Saving is Inadequate

Older Americans are entering retirement with too little money to maintain their consumption in old age. This conclusion is based on my study of a valuable new nationally representative data set known as the Health and Retirement Study (HRS), a longitudinal survey of some 12,000 Americans first collected in 1992 and continuing every two years. Using this database, James Moore and I at the Wharton School find that the median older American household in its mid 50's falls far short of target retirement saving. Indeed, our projections show that the typical couple must save *one quarter* of its annual gross income over the next decade, to be able to preserve consumption levels into retirement.

This concern is exacerbated because there is reason to worry that life expectancies may increase faster than expected. Another concern is that social security benefits could turn out to be much lower than currently promised. Under current tax and benefit rules, social security will make up 40% of older Americans' retirement wealth, so any change in this program will have widespread effects. But as we know, these promises cannot be met and the system faces insolvency around the time the Baby Boom retires.

Privatizing versus Prefunding Social Security:

In discussing social security reform options, a wide range of proposals has been put forward. But an issue that is often unclear, one worth clarifying at the outset, is whether a given proposal seeks to privatize or to prefund social security. These two concepts are frequently confused in public debate but should be carefully separated. Let us define privatization to signify that individual accounts are established, held in workers' names, and *prefunding* to mean the reduction of outstanding implicit and explicit debt associated with social security.

It is important to distinguish between these, because they produce very different outcomes. For instance, one reform might establish individual accounts that lack assets: this has occurred, for instance, in Latvia which has mandated so-called "virtual" IRA's. Alternatively, a different reform would raise taxes and cut benefits so as to build up a huge Trust Fund, invested by the government. This second approach, I would argue, could then be seen as funded, but not privatized; it is the pattern taken by Malaysia, where the federal government manages the Employee Provident Fund centrally. Some countries do both: for instance, Chile mandates that workers hold assets in individual accounts, and the old system debt is being paid off over time.

How the social security system should be reformed in the US can beneficially be split into a discussion regarding what has happened in the past, and what could occur in the future.

Managing Past Social Security Obligations

The US social security system is mostly a pay-as-you-go system: that is, the bulk of the tax revenue collected each year is needed to pay benefit costs that same year. By law, any annual surplus- which totaled about $70B in 1997 - is invested in special-issue Treasury obligations. The cumulative value of the OASI Trust Fund is currently about $584B, or 1.6 times a single year's benefit payments. This Trust Fund is expected to grow and then be depleted over the next 30 years, when the Baby Boom generation retires.

The OASI system is far from fully funded: indeed, the unfunded present value of past social security promises stands at $9 trillion. This computation assumes that liabilities are measured from the perspective of a "closed group" - that is, past promises are kept, but workers pay no future taxes and accrue no future benefits. From this perspective, the OASI system has a funding ratio of only 6.4%; this compares to a 100% funding ratio that private pension plans are mandated to have under ERISA.

Where did this obligation come from? The answer is that when the social security system was first set up, it was structured so as to provide the already-old with benefits, even though they had paid relatively little into the program. While this is not unusual for the early stages of a defined benefit pension system, it is not widely recognized that the subsidy continued for people born between about 1876 and 1936. This is 60 birth cohorts, if we define a cohort as those people born in a given calendar year. Specifically, the social security subsidy was on the order of $10 trillion for workers born before 1936. But somebody must pay for these transfers, so on average, everyone born after 1936 must get back less than they pay in over their lifetimes. This process has already started: workers born after 1936 have already paid in about $1 trillion more than they will receive, on average, thus reducing the system debt to its current $9 trillion level.

A hypothetical way to visualize the size of the unfunded social security liability is to imagine that every worker today might be taxed a lump sum of about $60,000 (not that everyone could pay it!). In round numbers, this would be sufficient to cover the liability due to past social security promises. At that point, the social security system would be funded on an accrual basis, and a strategy would have to be devised to manage that asset pool.

A more politically feasible way to allocate the burden of the social security subsidy might be one that allowed current workers to pay less. Of course, this would in turn pass more of the burden to future generations of workers. As an example, one could ask all workers to pay a constant percentage of their earnings to cover the past obligations owed to those born in 1936 and before. If we spread the start-up costs this way, it would require each cohort to give up about 25% of its current social security contribution, or in other words about 3 percentage points out of the current 12.4% payroll tax. So the ultimate result is that all current and future workers would have only three-quarters of their payroll tax left to invest in a funded account, after the needed tax levy is removed to pay for old promises. This is one reason that the perceived return from social security is lower now than for previous generations: current and future workers must pay for the net subsidy given to past workers. This state of affairs has not come about because of waste or inefficiency, but rather because social security provided substantial subsidies to the first 60 cohorts of retirees under the program.

Structuring Future Social Security Obligations

One commonly heard response to the social security system's projected solvency problem is to let people invest their social security taxes in the private capital market. The rationale usually given is that social security provides "even traditional families with children a return of less than 3%. That's a rate that would get any director of any investment company fired." In other words, the argument is that investment of social security taxes -- particularly in stocks -- would generate higher retirement benefits than could be obtained from the current program.

One problem with this position is that many supporters bypass all discussion of the system's past obligations. Instead, they focus attention on how a national 401(k)-type scheme might work, one that would be the repository of future tax receipts going into individual funded accounts. This is in fact feasible: the old system could be shut down, and the government could simply issue recognition bonds that would pay off so as to exactly reproduce benefit payments under the old system. All new social security taxes would then go to these individual accounts, where people could invest them. The question that then arises is whether worker could do better with these investments than they could do under the old social security system.

An examination of historical stock returns shows that average stock yields were 9.4% over the period 1926-1996. Intermediate term government bonds yielded 2.3%. If the past forecasts the future, then both of these returns exceed projected paybacks from social security taxes. Thus internal rates of return for a (solvent) social security system are estimated to be about 2% for those born 1950-75, 1.8% for those born in 1975, and 1.5% for those born in 1998 and thereafter. So on the face of it, future cohorts could apparently do better by investing in private capital markets, particularly stocks.

But this perspective overlooks the fact that stocks are riskier than bonds, so holders of stock funds would have to use higher discount rates to make equities comparable to bond investments. Some households, if they were prevented from accessing the stock market on their own, might find that these extra returns in their individual accounts would outweigh the additional risks. Other families, however, would judge the risk-adjusted rates of return on stock investments to be comparable to returns on government bonds.

Another caveat is that the current social security system provides workers with insurance benefits that might not be available to individual purchasers using individual account funds. These include insurance for disability, unexpected longevity, and inflation, among other things. The loss of these features is not generally accounted for in the simple "money's worth" comparisons, yet would (if properly valued) make the government-run defined benefit program worth more than commonly realized.

An additional consideration is that setting up individual accounts does not sidestep the question of who would asked to pay for the $9 trillion worth of past social security obligations. If taxes were raised to service the debt on the recognition bonds, these new taxes would likely eliminate the (risk-adjusted) gain to investing in private assets. Therefore, while it is true that returns to social security taxes will be low for future workers, there is likely to be few costless ways to raise them.

Practical Issues Regarding Individual Accounts

There are several important advantages of individual accounts that bear mentioning. One is that Baby Boomers worry about whether they will have the will or desire to impose the huge taxes needed to sustain the current underfunded system on their children and grandchildren. Individual accounts will likely reduce workers' and retirees' political uncertainty in this regard.

A second advantage is that households would have greater choice and control over their retirement investment portfolios, in the individual account scenario. This has both economic and psychological aspects. As noted above, the economic advantage is that some households would be better off since their individual accounts would give them access to the stock market that they would not have access to on their own. The psychological advantage is that people would be constantly reminded of the need to save for retirement, and the need to exercise choice over their investments with the retirement target in mind. Indeed, recent research suggests that greater financial education enhances workers' pension participation and raises the equity share of their investment portfolios in their 401(k) plans.

A third advantage of individual accounts is that there is less likelihood that political factors will play a role in investment decisions. My research on public pension funds shows that state and local pensions have been influenced by noneconomic ("social") investment rules, as well as the composition of the Boards governing the funds. Specifically, having retirees on the pension system Boards appears to reduce pension investment returns, and plans required to devote a portion of their assets to state-specific projects earn lower returns. If the power to make investment decisions for billions (or possibly trillions) of dollars were granted to a politically appointed central Social Security Board, it is highly likely that many political pressures would come to bear.

One concern raised by opponents of social security privatization is that privately-managed systems would be more costly than public systems to manage. My research indicates that costs incurred by the current US Social Security Administration are lower than those of some private sector money managers, but the current Social Security system also provides fewer services to plan participants. A low-cost privately managed individual savings account managed though an existing mutual fund or 401(k) plan would likely require money management fees ranging between 1 and 20 basis points for a passively managed indexed portfolio, and administrative costs of under $50 per year. A national TIAA-CREF-type or Federal Thrift-type plan would experience still lower investment costs, on the order of a basis point or less per year, with record-keeping costs around 20-30 basis points. Such additional expenses would make possible a system that handles the pension system's necessary functions with greater alacrity, while permitting workers to chose their investments, and if they wished, to undertake more active asset management in their retirement portfolios.

Other Approaches To Keep In Mind:

What else might Congress do to help Americans confront a wider range of options that they can use to help them plan for, and live with, a healthy, well-financed retirement period? Several options should be considered:

Changes in social security benefits and taxes must be announced soon - with sufficient lead time for workers to adjust their savings, consumption and retirement plans. To achieve this, it is important to legislate changes promptly and to allow some delay in implementation, so people can plan for the future. The desirability of delayed implementation only increases the need for swift action.

Changes in social security taxes and benefits should be phased in over time, rather than implemented abruptly. Gradual implementation reduces the magnitudes of notches (different treatment of cohorts close in age) and perceptions of unfairness.

Policy regarding pensions and retirement saving is constantly changing and hard to anticipate. Regulations that are uniform, coherent, and less frequently changed would stabilize the environment for retirement savings decisions.

Public policy should encourage new investment in a wide range of retirement assets. To survive a long retirement period, people need not only financial assets, but also investment in health assets (prevention and exercise in middle age are key), intellectual investment (ongoing education and training are essential for successful retirement), investment in our families (strong families supporting the young may translate into care for the old later on), and investment in our communities (involvement at all ages builds social support networks). Your Committee can do a great service by integrating this investment perspective into the policy discussion.

People who can work longer should be encouraged to do so. The long term trend toward early retirement has abated slightly in the last decade, but the fact remains that most Americans retire around age 62 and even younger if possible. Since financing ever longer retirement periods is becoming fiscally unsustainable, raising the normal, and probably the early, retirement, age should be on the table.

To better predict strategies for successful aging, it is essential to support continued data collection for in-depth surveys of older Americans, such as the Health and Retirement Study. Congressional understanding and sponsorship of these efforts is therefore essential, and support from this Committee will be crucial.

Conclusion

To conclude, saving shortfalls confront those now on the verge of retirement as well as the baby boomers next in line. The stock market's good performance over the last twenty years, the growth of 401 (k) pensions, and the projected social security shortfalls have been instrumental in building support for an individual account system as a model for social security reform. Individual accounts have a great deal to offer, though structural concerns still need attention. Even so, the old unfunded liabilities of the social security system must be dealt with explicitly as we move toward new models of retirement income provision. And the sooner are the adjustments legislated, the better, because early notification of impending changes gives people time to adjust their savings and retirement plans accordingly. Thank you for including me in this hearing, and I commend the Committee for its interest in and concern about retirement issues

Mean Value and Composition of HRS Wealth (1992) by Wealth Decile

Wealth Decile	Total Wealth	Net Housing Wealth	Net Financial Wealth	Soc. Sec. Wealth	Pension Wealth
1	$ 39,470	$ (5,719)	$ 1,520	$ 42,312	$ 1,356
		-14%	4%	107%	3%
2	97,452	11,052	10,579	69,239	6,583
		11%	11%	71%	7%
3	156,288	24,951	18,235	93,920	19,181
		16%	12%	60%	12%
4	219,797	37,095	32,632	115,224	34,845
		17%	15%	52%	16%
5	287,692	53,787	55,020	128,377	50,509
		19%	19%	45%	18%
6	364,802	68,637	75,793	136,116	84,255
		19%	21%	37%	23%
7	459,858	81,432	109,811	142,981	125,635
		18%	24%	31%	27%
8	590,079	95,414	159,054	149,310	186,301
		16%	27%	25%	32%
9	804,934	112,039	265,967	158,976	267,953
		14%	33%	20%	33%
10	1,764,414	180,894	1,032,049	161,605	389,865

		10%	58%	9%	22%
Overall Mean	478,313	65,940	175,974	119,793	116,606
		14%	37%	25%	24%
Median 10%	325,157	**59,746**	**66,530**	**133,606**	**65,275**
		18%	**20%**	**41%**	**20%**