Reforming Social Security
Testimony for the President's Commission to Strengthen Social Security
Rudolph G. Penner

Chairmen Moynihan and Parsons and members of the Commission, thank you for the opportunity to testify. I regret that the change in the date of the meeting created an irreconcilable scheduling conflict for me, and I apologize for not appearing in person.

Because of the demographic pressures described so well in the first report of this commission, the Golden Era of our traditional pay-as-you-go Social Security System is over. The ratio of benefits to taxes paid over a lifetime must fall dramatically over coming decades if the system is not reformed significantly.

It is therefore important to reduce our reliance on pay-as-you-go financing and to move toward a funded system where benefits depend on the rate of return to real investments and not on demographic factors. However, it is important to be careful how "funding" is accomplished. An individual can be given rights to the proceeds from a fund invested on his or her behalf, but if the fund is entirely financed by drawing down other savings in the economy, the nation's capital stock and future GDP is not changed. Pensioners are funded as individuals and this will allow pensioners to claim a higher portion of future GDP, but it comes out of the living standards of younger households. Funding can only add to everyone's future income if pension saving is created out of new saving, so that the nation's capital stock and the GDP pie is bigger in the future. Then, pensioners can have a bigger feast without shrinking the piece going to younger people. Unfortunately, it is not an easy political or economic trick to save more, because it involves an immediate fall in consumption and people do not like that.

Theoretically, true funding, involving an addition to national saving, can be accomplished by the public sector or through the creation of individual retirement accounts that are directly owned by workers. However, it is my judgement that it is more practical to accomplish funding through individual accounts for two reasons. First, to do it publicly, the government must on average run a substantial overall surplus that is larger than it would run otherwise by an amount equal to the annual investment necessary to fund future pension promises. Efforts to create a lock box for the Social Security surplus appeared to be on the brink of failure before the September 11 attack, even though the current surplus is far less than necessary to fund our current system. Since the attack, it will be impossible to re-lock the lock box for a large number of years for good substantive reasons, but recent developments illustrate the practical difficulty of using government to fund a pension plan.

A second problem arises with a public approach to funding, because the most practical and direct approach to giving pensioners the rights to the return from the capital created by true funding would be to have the trust fund invest in equities and I believe that most Americans, most certainly including me, would be reluctant to give the government that much power in equity markets. Admittedly, the government could achieve the same goal indirectly even if the trust fund stayed fully invested in government bonds. The general tax burden could be increased to drain off some of the extra income generated by a larger capital stock and the interest income of the trust fund could be supplemented by general revenue contributions. However, this would break the important psychological link between benefits and contributions and may not be sustainable politically.

Achieving an increase in national saving from a carve out approach to individual accounts is not simple either. The diversion of some payroll taxes from the trust fund into individual accounts at first reduces government saving if spending is not reduced or other taxes raised to finance the carve out. Immediately reducing spending on Social Security is impossible because of the consensus that you cannot immediately cut the growth in traditional benefits for the already retired or those approaching retirement. At the same time, it is not clear that the entire deposit in an individual account represents additional saving. The person creating the new account may choose to reduce deposits in old pension accounts such as 401k's. The initial impact on national saving can be negative, but if the carve out is eventually financed by reducing the growth in traditional benefits, the long-run positive impact on national saving could be very large while providing pensioners with a higher total retirement income than otherwise possible. Private saving would rise because it is in most participants' interest to save an extra amount sufficient to at least make up for the loss of traditional benefits. I have little objection to borrowing somewhat more in the short run if it eventually brings us to a long-run situation in which the borrowing can be repaid with much saving left over. Another way to put it is that we might increase our explicit debt somewhat (or not reduce it as much) in order to rid ourselves of a the larger implicit debt represented by benefit promises.
Alternatively, any possibility of an initial negative impact on national saving can be avoided by having the government run a tighter overall fiscal policy as we transit to individual accounts, but this would not be easy politically. It is unfortunate, in my view, that we have ruled out even small immediate reductions in the growth of benefits of say one or two percent for the already and nearly retired. Immediate action can obviate the later need for much bigger reductions in the growth of benefits.

If we move toward individual accounts, we have an enormous advantage in that numerous countries have preceded us with a multitude of approaches and designs. We can learn a great deal from both their successes and their mistakes.

There are many issues that must be decided in designing individual accounts and I shall focus only on three—dealing with the risk inherent in the accounts, dealing with the distribution of retirement income and controlling administrative costs. I shall go on to discuss some research that Elizabeth Cove, a colleague at the Urban Institute, and I did on how different types of women would fare under a carve out system of individual accounts.

In most countries that I know with individual accounts and in all the major proposals in the United States, there is some degree of risk sharing between the government and individual. It is said that government is better at spreading risks over different age cohorts. I must confess some skepticism on this point, because if government was really good at risk spreading, we would have reformed Social Security long ago. Delay increases the size of the necessary adjustment and increases the risk to future participants. Nevertheless, many proposals deem it appropriate for government to reduce risks to the individual one way or the other in the hope that the entire risk won't come back to the individual in the form of abrupt tax increases or spending cuts.

I would distinguish two fundamentally different approaches. One creates a safety net for those who were unlucky in either their investments or their earnings history. The safety net can be as generous as one wants to make it, but if it is very generous, it is necessary to demand compulsory annuitization of the individual account or else there is a strong incentive for people to go on a consumption binge upon retirement and throw themselves into the safety net. That happens in Australia. I would rather not have such a generous safety net, so that compulsory annuitization could be avoided. It is very complicated to design.

The safety net can take the form of an improved welfare system, e.g. making SSI more generous, or creating a new more generous minimum benefit under Social Security. I prefer the former because you can make a welfare program depend on household income whereas a Social Security minimum benefit must depend on an individual's earnings record. There are a remarkable number of women with low average lifetime earnings who live with affluent husbands. Consequently, a larger minimum benefit is not carefully targeted to people who really need it. Those who prefer a high minimum benefit point to the apparent stigma attached to SSI which leads to a very low participation rate among eligibles.

Another approach to risk sharing makes the size of the reduction in traditional benefits depend directly on the amount earned in the individual account. Martin Feldstein and Representatives Archer and Shaw have designed plans of this type that leave the individual with a guarantee that they will receive benefits at least as large as those provided by current law. Of course, if the individual has little risk, the government must bear a lot. This leaves the government with a huge and uncertain contingent liability. I would much rather leave more of the risk with the individual and use an enhanced safety net to take care of unfortunate cases.

Much of the rhetoric surrounding this point greatly underestimates peoples' ability to deal with risk. It must first be noted that the reform plans being discussed today are relatively modest. The most radical generally involve a two percentage point carve out of the payroll tax. Even if traditional benefits are cut sufficiently in the long run to finance the carve out, the bulk of most individual's retirement income will still come from the traditional system. Unless rates to return to the individual accounts are very high by historical standards, traditional benefits will be more than twice the amount earned from the individual accounts. If an investor was foolish enough to be invested entirely in equities on the eve of retirement and experienced the recent 27 percent peak to trough fall in the Dow Jones by converting to an annuity at the trough, retirement income from traditional benefits and the individual account would be considerably less than 10 percent lower than at the peak and the individual would have earned a rate of return on the individual account far in excess of what will be possible in the future from the traditional system. That implies that the risks associated with a reform of this type are small compared to the ordinary risk of living. People must deal every day with huge uncertainty regarding their future earnings, their health, etc. and largely, they do it quite successfully. It must also be emphasized that the traditional system is today creating much uncertainty for individuals. They know that it is not sustainable. They do not know how it will be changed.

The distributive characteristics of individual accounts are, of course, linked to how you deal with risk. A generous safety net will obviously make the distribution of retirement income more equal. The more fundamental point is that just as you can make the distribution of risk between the government and individual anything you want in an individual account system, you can achieve almost any distribution of retirement income that you deem desirable.

There are two basic approaches. You can redistribute after all investment outcomes are known by creating a safety net. Alternatively, you can redistribute in advance by subsidizing the contributions of lower income participants. Technically, I prefer the former approach. It can be better targeted and I suspect that it will be easier to administer. On the other hand, there is a considerable amount of political appeal in allowing lower income people to accumulate more assets than would be possible on the basis of their own income. The philosophical advantages of giving all households a significant stake in the wealth of the nation may outweigh
The administrative costs associated with an individual account system can vary greatly depending on the services provided by the account and the nature of the restrictions on trading. Frequent trading and reporting and consultations with investment advisors can be very expensive and eat into the return to capital. My own inclination would be to establish a bare bones system at first that did not allow much trading. I believe that the Social Security Administration should run the information system and that the whole system should function with rules similar to those governing the civil service thrift system when it started. (The rules have offered more choices over time.) I heard a Swedish official state that they expect to run their new individual account system with an administrative cost of 0.7 percent of contributions. That will imply a remarkably low cost relative to assets once the system gets going. I don't know the details of how they keep costs so low, but clearly, it is probably worth some investigation by the Commission. More generally, the Swedish reform is ingenious. They have restructured their pay-as-you-go component so that it automatically adjusts for demographic and economic surprises and at the same time they have established a significant individual account system. This commission should be forewarned, however, that it took much longer than anticipated to create the information system for the individual accounts. It is a complex task.

Along with my colleague, Elizabeth Cove, I have researched the implications of a carve-out, individual account system for different types of women in which traditional benefits are reduced both to eliminate the financial shortfall facing the system and to finance the carve out of payroll taxes. The Urban Institute's Dynasim model is used to project the demographic composition of the population and the economic wellbeing of different groups in 2040. It is assumed that the individual account system had, by then, been in force for the entire working career of almost all retirees.

The study was undertaken in response to a number of commentaries that implied that the traditional system was particularly generous to women and that they would suffer as a result of any move to individual accounts. This conclusion seems puzzling, because it is obvious that some groups of women are not treated very well by the traditional system. In particular, divorcees married less than 10 years have no rights to their ex-husbands Social Security benefits, but they would presumably have some rights to his individual account. Women who receive the spousal benefit get nothing for any payroll tax payments they might have made during a career whereas they would get something from an individual account. The one group that would clearly suffer unless some special provision was made are survivors with more than one child and the Commission should worry more generally about survivors when they design their proposals.

To make the current system whole in 2040, a 27-percent cut in benefits is needed to balance revenues with pay-outs and another sizable cut would be needed to finance the diversion of two percentage points of the payroll tax into individual accounts. In all, benefit cuts total 40 percent. If financial markets follow historical trends, earnings from a mixed portfolio of stocks and bonds would beat inflation by 5.5 percent after reasonable administrative costs were deducted. For 99 percent of all women, that's more than enough to offset the benefits cuts used to finance these accounts. Even if their investments returned only 4 percent a year, 92 percent of all women would earn enough on them to make up for the difference between a 27-percent and a 40-percent cut.

Would women in different family and financial situations fare the same? Roughly speaking, married women, widows, divorced women, and never married women would. That said, women with high average lifetime wages would come out ahead of women who earned less. But, assuming a 4 percent real rate of return nearly 70 percent of those who made less than half the average would be better off with than without individual accounts. Many of the poorest of these women would qualify for Supplemental Security Income, the welfare program for the elderly and disabled, so Social Security reform wouldn't touch them much anyway. Moreover, our analysis assumes that all traditional benefits are cut proportionately. The reform could be structured to shave the gains of the more affluent in order reduce the cuts toward the bottom of the distribution of lifetime wages.

In conclusion, the Commission faces an enormous number of choices in designing a reform based on individual accounts. The objections that one often hears that individual accounts are too risky or too regressive or too expensive to administer can all be handled easily. What can't be handled easily are the promises made by the current system.

Other Publications by the Authors

Rudolph G. Penner