Statement of Dr. Olivia S. Mitchell
International Foundation of Employee Benefit Plans
Professor of Insurance & Risk Management
The Wharton School of the University of Pennsylvania

Testimony before the Senate Finance Committee
Hearing on the Final Report of the President's Commission to Strengthen Social Security
October 3, 2002

Chairman Baucus and Senator Grassley, I thank you for this opportunity to address the Senate Committee on Finance. On behalf of the President's Commission to Strengthen Social Security, I would like to commend you for your attention to the challenges facing Social Security.

My name is Olivia S. Mitchell and I am a Professor of Risk Management and Insurance at the Wharton School of the University of Pennsylvania. I recently served as one of 8 Democratic members of the 16-member bipartisan Commission to strengthen Social Security, a group that reported out last December under the leadership of Senator Daniel Patrick Moynihan and Richard Parsons.

I would like to begin by saying a few words about the Commission. When I was invited to join this group, I felt it essential that we embody the integrity and bipartisanship needed to strengthen Social Security. Our Commission was charged with improving the sustainability of Social Security -- **without changing benefits for those now or near retirement, without raising payroll taxes, and while establishing new savings opportunities through personal accounts.** I am very much gratified that our Commission was able to satisfy these charges by presenting proposals that **enhance progressivity, reduce systemic risk, and allow freedom of choice in a way that the system has heretofore never permitted**. These objectives, we believe, can be achieved, within a reformed and fiscally sustainable system, which promises benefits higher than those currently payable and, in many cases, higher than those expected under current benefit promises. Our proposals were also rigorously scored by the Social Security Chief Actuary, a high standard that we invite other interested parties to meet, by submitting their own plans.

The Commission achieved something that no prior commission has done, namely to produce a consensus report with recommendations to make Social Security **not only solvent but permanently sustainable**. Further, each of the reform models we proposed would **establish personal accounts within the context of the Social Security system.**

Mr. Chairman, some might imagine that one could reform Social Security without personal accounts. Indeed, Social Security financing might be temporarily enhanced without personal accounts, simply by shifting mounting costs onto future generations. But as an economist, I find this a fundamentally unsatisfactory approach, and I would suggest that it might not be a politically sustainable solution either. Indeed, there is probably no "perfect" solution; instead, meeting the challenges of Social Security via personal accounts seems to me, and seemed to the Commission, to be a preferable path to the unappealing alternatives, namely raising taxes, or cutting benefits.

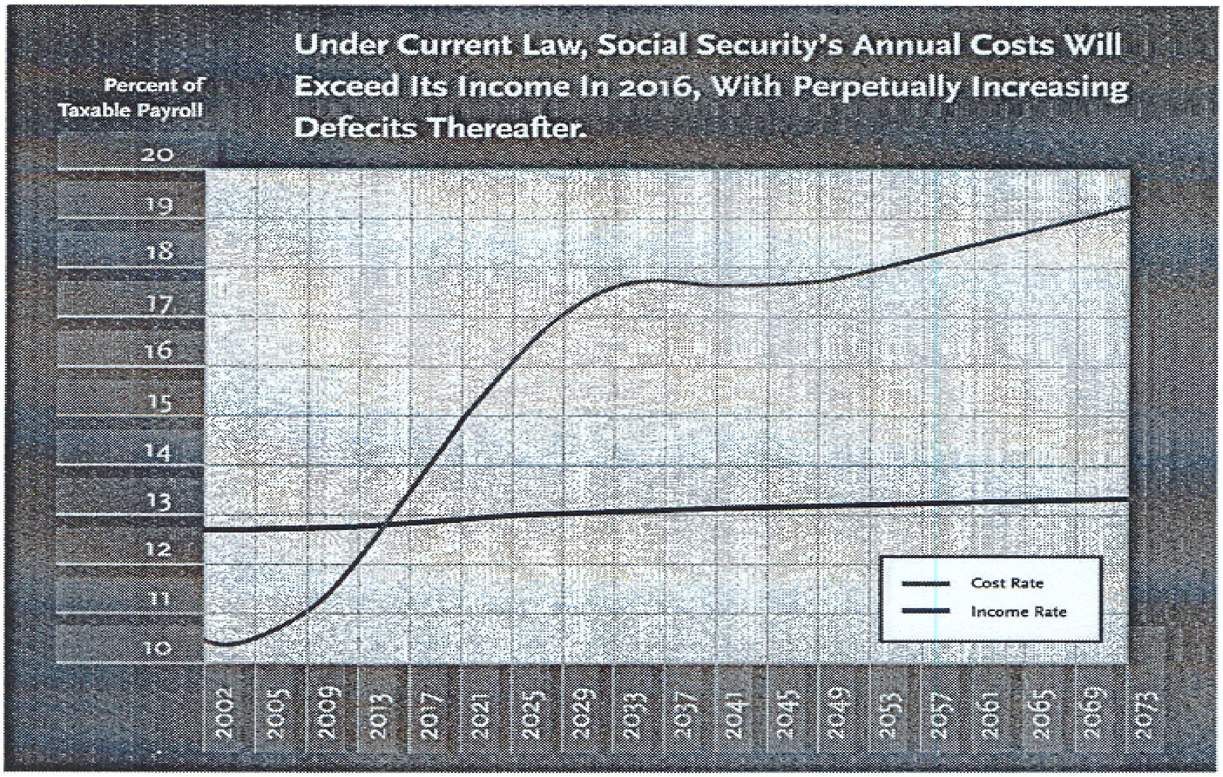
In the end, however, the main reasons to create personal accounts in Social Security are positive, not negative. One benefit of a properly designed Social Security personal accounts systems can be a **permanently sustainable Social Security system**. Another can be **higher benefits than the existing system can pay**. Still others are possibly **greater national saving, greater individual control,**

inheritance rights, new protections for divorced women, and, as Co-Chairman Senator Daniel Patrick Moynihan has emphasized, the first **opportunity for millions of Americans to accumulate wealth.**

Addressing the Challenge of Social Security Sustainability: The Available Choices

The fiscal challenges facing the Social Security program are summarized in the following chart (Figure 1.)

Figure 1.



In developing this chart, the Commission worked with the 2001 Trustees' Report estimates, which showed that Social Security's benefit obligations will start to exceed annual cash income in 2016. (This date has shifted to 2017 in the most recent Trustees' Report.) At this point, the federal government will have to allocate additional cash to the Social Security program to cover promised or scheduled benefits. Specifically, Congress will have to allocate not only all projected payroll tax dollars, but also more additional revenues to redeem debt held by the Social Security Trust Fund. The figure shows that, under current law, these costs will escalate very rapidly, and the revenue and cost lines will forever pull further apart.

This figure shows that system "solvency" is only one piece of a much more difficult problem. That is, "solvency" might be achieved in theory, simply by raising the level of interest paid to the Social Security Trust Fund. Or it could be achieved by raising payroll taxes today, even if that payroll tax money were used to finance current expenditures (for example, to finance a war or additional income tax cuts). But here is the critical point: such measures would do <u>nothing</u> to address the fundamental underlying problem, which is the program's unsustainable cost growth relative to the size of the economy.

We cannot take credit for "solving" Social Security by shifting ever-increasing costs onto future taxpayers.

Social Security will not be sustainable – either fiscally or politically – unless in the long run, its annual dedicated income exceeds its payment obligations, *without* relying on appropriations from the rest of the budget. As my colleague, former Congressman Tim Penny urged at one of our Commission hearings, **we must get these lines to cross again**. The system must return at least to cash-flow balance, not only now, but for the future as well. The Commission accordingly rated all proposals according to how much progress they make toward this goal. This was the critical test facing the Commission, and which I believe today faces the Congress of the United States. I would therefore encourage this Committee to subject all proposals to a similar evaluation, as it examines alternative means of shoring up Social Security.

In our Commission report we illustrated the choices facing those who are serious about taking on this challenge. For each of our proposals, we showed the operations of Social Security assuming no participation in personal accounts – as though the personal accounts had not been established – and also assuming, respectively, 2/3 and 100% participation. This is crucial since there is some uncertainty about exactly how many workers under the age of 55 would take up personal accounts. As we point out many times in our report, no one age 55 and over would have benefits affected in any way by these plans.

The analysis of Commission Model 2 (without the accounts) shows that if the system were converted from wage indexing to price indexing, the plan would attain full actuarial balance without raising payroll taxes and without cuts in the real value of benefits. Other approaches lay out alternative options for the Congress: for instance, Model 1 (without the accounts) shows the ramifications of keeping current benefit formulas in place, which would require the allocation of an additional $22 trillion (in 2001 dollars) or $5 trillion (in present value) of on-budget revenues in order to remain solvent. In each case, however, expected benefits will be higher for most workers under the personal account plan than without. In other words, no benefits would be cut relative to current payments, and in most cases benefits would be higher. In fact, long-term low-wage workers would be substantially better off as compared to the benefits that can be financed under the current system.

Helping Social Security Fulfill its Promise to Beneficiaries

In addition to fiscal issues, the Commission looked closely at the treatment of individual Americans under the current Social Security program. **We found many reasons for concern**.

One clear and systemic problem has to do with the **worsening treatment of young Americans**. In our Interim Report, we showed that a boy born in 2000, if he remained single all of his life and earned an average income, could expect only a 0.86% real rate of return from Social Security. A girl would anticipate only a return of 1.25% on her taxes, and a dual-earner married couple, a 1.88% rate of return. While rates of return are not the only relevant measure of the system's equity, it is clear that perpetually plummeting rates of return threaten not only the program's efficacy but also its political support.

Commission members were also concerned about how the **program fails to redistribute income to those who need it most**. For example, the current system redistributes money from those with shorter lifetimes to those with longer lifetimes, and from single individuals to traditional one-earner married couples. Both of these elements work against the progressivity of the existing system.

These issues are complex, and no single prescription addresses them all. We sought, however, to **enhance the safety net for certain vulnerable populations, particularly divorced women** who currently gain no entitlement to benefits based on their years of marriage, despite being at very high risk of poverty. We also proposed **benefit enhancements for surviving widows and widowers** most at risk for low income in old age.

A Brief Description of the Commission Proposals

I would like to briefly describe key aspects of our Commission's proposals, since others speaking before you today will offer their own interpretations of our plans. I will focus in the interest of time on what we called "Commission Model 2" because it is the one that passes the most rigorous tests of fiscal sustainability. When constructing Model 2, the Commission pointed out that the current wage-indexed benefit formula is inherently unsustainable within the demographics of our nation. We concluded that the ***entire* actuarial imbalance in Social Security over the next 75 years could be accounted for by growth in initial benefits beyond inflation**: in other words, if the benefit formula were indexed to grow with prices rather than wages, the system can be placed on a sustainable course. This would enable the government to maintain actuarial balance while offering benefit growth *above* existing law for low-income earners and for widows.

Model 2 contains a provision that would gradually <u>increase</u> defined benefits for low-wage earners, added benefits that some have neglected to mention. When fully phased in by 2018, the provision would ensure that any individual who worked for a full career at the minimum wage would receive a benefit that is 20% **higher than the poverty line**. Model 2 also would **expand benefits for low-income widows**. This reform plan also provides individual participants with an opportunity to invest 4 percent of their wages into a personal account, up to a maximum of $1000 annually (a figure indexed to wage growth.) The account would be set up so that participants would have higher expected benefits than from traditional Social Security, providing that the personal account accumulates at faster than a 2% real rate of return.

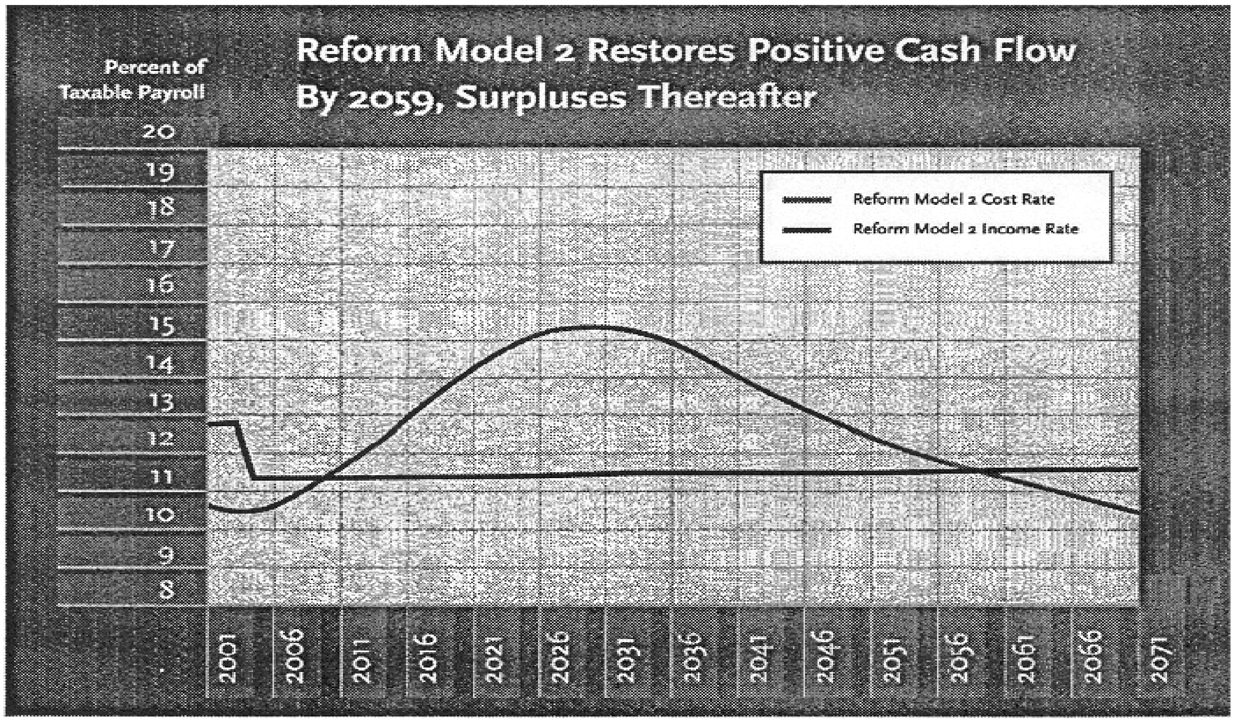
The SSA Actuaries' projections show that this personal account option can provide higher expected total benefits than can be paid under the current system, and in addition, benefits would be enhanced for many taxpayers. The attached chart (Figure 2) show the extent of the increases individuals can expect if they opt for the personal accounts.

We also devoted substantial attention to plan design, and intentionally we modeled these personal accounts very closely on the federal government employee's Thrift Savings Plan. I emphasize that the TSP is not a "privatized" system, but an effective and safe means of saving and investing that has benefited countless federal employees. In these personal accounts, individuals would have the opportunity to invest in broadly diversified funds – an inflation-indexed Treasury bond fund, a stock fund, and others. There would be no "day trading" or "stock picking."

Financing Results

I should also emphasize that the Commission took seriously its charge to **enhance fiscal sustainability** (see Figure 3). If no one opted for personal accounts, the actuaries project that permanent cash surpluses would begin in 2062 under Model 2's reform. If everyone opted for personal accounts, cash surpluses would begin somewhat earlier, in 2058. While we don't know exactly how many people would opt for the accounts, and this would depend on a national educational campaign, **structuring the personal account properly would ensure that the accounts accelerate progress towards the system's permanent sustainability. Figure 4 illustrates that this can be done very affordably. Of course,** there is an investment required when moving to a funded system, which under Model 2 lasts from 2005 to 2029 and is then balanced by a payback period from 2029 onward. The Commission defined transition costs as the **net additional general revenue requirement associated with the proposed reform**, for the years when additional resources are needed to cover promised benefits and fund the personal accounts. In present value terms, Model 2 requires $0.9 trillion or about half of one percent of GDP, between now and 2029. (These transition financing requirements are initially quite small, $4 billion in 2010, and grow to a maximum of just over $73 billion in 2016 (in $2001). Thereafter, the amount of new cash requirements for the reformed system would diminish. Starting in 2029, the new system would require less general revenue than the old one on a permanent basis.) The Commission concluded that this amount was comparatively small and would not pose major economic or budget concerns, particularly compared to the alternative of doing nothing.

Figure 3.



In order to fully evaluate the effects of reform, we constructed a rigorous "fiscal sustainability report card" for each of the Commission's reform Models. I would note that we ourselves did not fill in the results on this scorecard – we left that to the independent analysis of the Social Security actuaries, who updated the table on July 9 of this year. I include this table with my testimony (Figure 4). It shows clearly how these models for reform improve significantly upon current law.

Time forbids a similarly detailed discussion of Commission Models 3 and Model 1. But each of these, too, is illustrative of specific philosophical choices that could be made. With my testimony, I would like to enclose a copy of the Executive Summary of the Commission Report, which provides additional details on each of the Commission proposals. This Executive Summary restates the President's principles for strengthening Social Security, reviews some design elements that are common to all three of our reform models, presents the most significant provisions of each model, and summarizes each model's expected benefits and fiscal projections.

Towards a Productive Discussion on Social Security Choice

The Commission recommended a year of discussion of Social Security before legislative action is taken, and I commend the Senate Finance Committee for furthering this discussion today. We on the Commission are accordingly quite pleased that others have come forward with constructive suggestions for shoring up Social Security. Since the release of the Commission report, we have been sent proposals in the same vein, sponsored by bipartisan teams such as Congressmen Kolbe and Stenholm, as well as Congressmen Clay Shaw, Dick Armey, Jim DeMint and Peter DeFazio.

Throughout our Commission deliberations, we met with interested individuals from both sides of the aisle, and we sought input from all quarters. Some opponents of personal accounts testified before the Commission and promised to send us specific plans for evaluation if we ourselves developed specific plans, but they failed to do so. I would urge this Committee, in fielding testimony on the Commission proposals, or any other proposals, to pose the following questions of Social Security experts:

- What is your proposal for making Social Security permanently sustainable?
- Are you willing to subject your proposal to the Social Security actuaries for evaluation by the same standards applied to those of the President's Commission to Strengthen Social Security?

We at the Commission find no fault with those who may have different ideas on how best to shore up Social Security. Yet to support such plans, proponents must be willing to put them forward for the same independent evaluation to which we subjected our reports. I have been told that critics of the Commission's work propose "taking personal accounts off the table" as a condition for providing proposals for Social Security reform. But Mr. Chairman, if personal accounts are off the table, and if the Commission's plans for sustaining the basic system are off the table, then there is nothing left *on* the table.

The Commission's proposals, we believe, offer reforms that are affordable, reduce risk, enhance progressivity, and offer workers the chance to build retirement wealth.

I, along with the 15 other bipartisan members of the Commission, stand ready to work with you to modify, improve, and develop the best elements of our thinking with the insights you bring from each of your constituencies. I therefore end my remarks by expressing my thanks for the opportunity to testify before this distinguished Committee, and by expressing hope that you and your advisers will propose and have fairly scored a range of reform plans that truly restores confidence in Social security.

I welcome your questions and thank you for your attention.