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STATEMENT BY BONNIE O'DAY, PH.D.

The solvency of the Social Security Trust Fund is a matter of critical importance to Americans with Disabilities. The Supplemental Security Income (SSI) and Social Security Disability Insurance (SSDI) programs provide an important safety net for the 9 million individuals deemed by SSA to be unable to work. These individuals and their advocates must be an integral part of the current Social Security debate.

SSI and SSDI beneficiaries must meet and document rigorous disability criteria to establish their eligibility for these programs. However, employment could be a realistic option for many of these individuals if they receive education or training, adaptive equipment, health care, and other support services. If only one-half of one percent of current SSI and SSDI beneficiaries went to work, the Social Security Trust Fund would save $3,500,000,000 over the worklife of these individuals. Providing reforms to enable some beneficiaries the opportunity to return to work is imperative for the solvency of the Trust Fund.

Several "work incentive" provisions have been added to the SSI and SSDI programs during the last twenty years, but they are extremely complex, difficult to use, and burdensome to both the Administration and the recipient. SSI recipients can retain $1 of their benefits for every $2 of earnings, deduct impairment related work expenses, and retain Medicaid benefits after earnings become too high to allow SSI cash payments. (Earnings limits are established by each state.) SSDI work incentives include a one-year trial work period; 36 months of extended eligibility for Medicare benefits, a Medicare buy-in program, and deduction of work expenses.

But evidence suggests that these work incentives are not well used. The General Accounting Office (GAO) found that about eight percent of SST recipients and one percent of SSDI beneficiaries aged 18 to 64 reported any earnings. Another 199 1 study of about 4,400 SSDI beneficiaries found that between 10 and 20 percent knew anything about work incentives under the SSDI program, and almost no one said they were influenced to return to work by these provisions (Hennessey & Mueller, 1 994).

Many people with disabilities find that it just doesn't pay to work. SSDI beneficiaries face a $500 earnings "cliff" ($1,050 for blind individuals) that presents a significant impediment to employment. An individual who earns over $500 per month (minus any impairment-related work expenses) will lose their entire SSDI check. This means that an SSDI beneficiary must find a job that pays about $20,000 per year and provides medical benefits, and a blind person must make about $25,000 per year, to profit by earning over the SGA level. The sensible course of action for most people is to remain unemployed, or to keep earnings low enough to retain cash payments. Based upon public hearing testimony, the National Council on Disability (1997) reports that SSDI beneficiaries turn down promotions, refuse increases in hours or overtime, or actually reduce their hours when their wages rise to keep their SSDT benefits.

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Access to medical coverage is also critical for SSI and SSDI beneficiaries to become employed in larger numbers. The gateway to full medical coverage, including durable medical equipment, personal assistance and prescription drugs, is eligibility for SSI benefits The entanglement of income and medical benefits results in the potential loss of medical coverage when earnings rise and cash benefits are eliminated upon return to work. A Harris Survey of Americans With Disabilities conducted in 1994 found that 31 percent of those who are unemployed find loss of health insurance or long-term services to be a work barrier. Ironically, the services and supports that enable an individual to live independently in the community and to sustain employment may be lost if he or she successfully finds a job. Part-time work that is becoming increasingly available and is well suited to people with some disabilities may not be an option due to lack of health care coverage. If health care is covered by the employer, in-home assistance, prescriptions, and adaptive equipment may not be covered, or may not be sufficient to meet the individual's needs. It therefore makes sense for SSI recipients and SSDI beneficiaries to refrain from or restrict employment to maintain publicly funded medical benefits.

Recommendations:

1. Enhance SSDI work incentives by offering a $2 for $1 income offset, similar to that offered to SSI recipients, for beneficiaries who earn over $500 per month. This provides a gradual ramp, rather than a sudden drop, off the SSDI program and enables beneficiaries to profit by working.

2. Simplify and enhance SSI work incentive provisions by allowing SSI recipients to keep the first $500 (rather than the current $65) of earned income. After this level of income has been attained, the current two-for-one offset would be instituted, but altered to be collectable quarterly rather than monthly, in $50 rather than $1 increments. This would simplify work incentive programs and decrease paperwork requirements by replacing current deductions for work expenses and other more complex work incentive provisions.

3. Institute a Medicaid buy-in for SSI and SSDI beneficiaries who return to work, thus allowing people to purchase health care coverage.

4. Contract with non-profit agencies to promote employment and to inform beneficiaries about work incentives.

The Social Security Reform Challenge: maintain the safety net, increase savings, bolster returns

By Ronald P. O'Hanley
President, Dreyfus Institutional Investors

Developing consensus for Social Security reform is arguably the most important and challenging domestic agenda item facing President Clinton and Congress today. Yet it is interesting that a child born this morning could grow up and attend college before the current pay-as-you-go Social Security program runs into financial difficulty. Our leaders deserve credit for having the foresight to address this issue today in a proactive manner. It is not often that we are able to build political momentum for major initiatives without an immediate crisis before us.

The Social Security Act signed by President Franklin D. Roosevelt on August 14, 1935 is perhaps the most important and enduring program ever enacted by our government. Every President and Congress since then has preserved this economic safety net. On several occasions during the past six decades, Social Security has been modified to meet new challenges and accommodate new demands along the way. Our elected officials, for example, passed what were seen as "landmark" amendments 15 years ago when political leaders as ideologically opposed as President Ronald Reagan and House Speaker Thomas "Tip" O'Neill worked to forge consensus on solutions at the time.

Faced with the widely documented demographic challenges posed by the large population of baby boomers approaching retirement and people living longer, we must once again modify the program. While there is already no shortage of good proposals, it will take time to develop a consensus for reform. There are, however, plenty of facts that will help guide us as we develop solutions.

Social Security replaces only about 40 percent of the average worker's pre-retirement earnings, according to the Social Security Administration, and yet it is the major source of income for two-thirds of elderly recipients and essentially the ***only*** source of income for the rest of the retirees. The government also says that while 11 percent of senior citizens in America live in poverty (sadly), the figure would be nearly 50 percent without Social Security. Finally, while 70 percent of Social Security beneficiaries are retireees, 30 percent--or 13 million of our fellow citizens--are receiving necessary benefits as survivors (widows and orphans) or because they are disabled.

Given these facts, a few things seem clear:

1. The safety net aspect of the Social Security system must be maintained. The program is key to the social well being of a substantial segment of our citizenry. Therefore, key elements of the current system--such as mandatory participation and the principle of a minimum level of guaranteed income--must remain intact.

2. Reform should include initiatives to increase savings levels and participation in private pension schemes. The fact that Social Security benefits alone will not suffice to maintain a retiree's minimum standard of living underscores the importance of creating new incentives to increase personal savings. Experts say that we need 70 percent of our pre-retirement income to maintain our lifestyle when we leave the workforce. Social Security, as you know, has long been viewed in America as only one part of a "three-legged stool" for retirement security. It was meant to be a guaranteed leg, while personal savings and private pensions comprised the other two. However, traditional pensions are becoming less common and less assured for today's workers--especially those in their 20s and 30s who will be employed by many different organizations during their careers.

This puts more of the burden on personal saving, yet Americans are saving less than 4 percent of their income today, half the rate only two decades ago. While the rest of the world admires our economic prowess, many countries have managed to significantly outpace us as savers in recent years. Boosting our low savings rate also would have positive implications for future prosperity through productive capital formation. Increased savings makes more funds available for investment, resulting over time in higher standards of living and productivity.

3. Improving investment returns is vital to reforming Social Security. We must take steps to broaden the asset allocation mix of the Social Security trust fund investments to reflect the liabilities of the system. Whether it is through individual accounts in which employees invest a portion of Social Security funds on their own or as a collective trust, it is essential that we strengthen returns. This requires investment in stocks and bonds in addition to Treasury obligations.

We all know the risks involved in stocks, as evidenced by this year's market volatility. But we also know the long-term track record of a diversified pool that includes equity investments when compared to other investments. U.S. corporate competitiveness and profitability has been driven in no small part by equity investments in pension plans that have reduced the need for corporate funding of these plans. Millions of average-income Americans have created significant wealth during the past several years by investing in the stock market through their 40 1 (k)s alone. Why not the same for our Social Security funds?

So today, the President and Congress have an opportunity to develop a blueprint to preserve Social Security--and the intergenerational bond that our country has cemented to provide for our elders and those among us who have fallen on hard times. This republic has met every major challenge for 222 years--and we will surely do so again on the issue of Social Security.

Individual Accounts: Lessons from the UK Experience

Dr. J. Michael Orszag [1]

The role of individual accounts in Social Security reform is perhaps the most contentious issue to be debated at this conference. The UK experience may help inform the discussion. In 1988, the UK took the groundbreaking step of allowing individuals to contract out of the earnings-related portion of the state pension (SERPS) by opening up personal accounts (Appropriate Personal Pensions). Since Britain is the only major industrialized country to experiment with these accounts, its experience provides a unique laboratory in which to investigate both the opportunities and problems of a switch to such accounts.

In terms of opportunities, establishment of personal accounts in the UK has had important incentive effects.[2] But the UK experience has also indicated a number of practical problems for policy design. In particular, the administrative costs of running individual accounts have proven to be surprisingly high, and misleading sales practices have produced a $15 billion scandal.

To evaluate administrative charges in the UK, it is useful to define ***the charge ratio,*** a measure of how much of a pension's value is dissipated due to administrative charges and other costs. In particular:

$$\text{Charge Ratio} = 1 - \frac{\text{Pension w/ Charges}}{\text{Pension w/ No Charges}}$$

The closer the charge ratio is to zero, the lower the costs. The charge ratio can be decomposed into three components, corresponding to losses upon retirement (annuitization), losses from building upon funds before retirement assuming no switching among funds (accumulation), and losses from switching among funds before retirement (transfer):

1. ***The annuity ratio*** reflects the losses from annuitizing an account at retirement. It measures the ratio of private annuity yields to theoretical yields from population mortality tables, and captures both adverse selection and cost loadings on private annuities.

2. The ***accumulation ratio*** captures fund management and administrative costs during the accumulation stage of a worker's career. It assumes that individuals do not switch funds during their careers.

3. ***The transfer ratio*** measures the costs from switching funds during a worker's career. It is computed as the ratio of the amount received at retirement by an individual switching funds a typical number of times to the amount that would have been received at retirement by the same individual if he/she had not switched funds at all.

When there is no lump sum pension payment, these ratios enter multiplicatively:

$$\frac{\text{Pension w/ Charges}}{\text{Pension w/ No Charges}} = \text{Annuity Ratio} \times \text{Accumulation Ratio} \times \text{Transfer Ratio}$$

In combination, these three sources of costs are substantial. Reasonable figures for the UK are an accumulation ratio of roughly 75% (consistent with a 9% equity yield, a 50 basis point fund

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[2] Stefan Folster, Social Insurance Based on Personal Savings Accounts; J.M. Orszag and Dennis Snower, Expanding the Welfare System: A Proposal for Reform in *European Economy,* 1997, 4.

management charge, and a 5 percent annual fee), an annuity ratio of 85%, and a transfer- ratio of 70%. The total charge ratio is therefore 1- 0.75 x 0.85 x 0.70 = 0.55, so that 45% of the pension is lost in charges. In other words, the value of a private account in the UK is cut roughly in half by administrative and other costs.

These high costs are not just hypothetical figures. We have calculated the three component ratios for the UK, using data back to 1988 (when personal pensions were introduced):

- Accumulation ratio. Data from ***Money Management*** surveys indicate an implied accumulation ratio for a typical worker who works 40 years of about 75% in 1997.
- Annuity ratio. For annuities, adverse selection and cost loadings amount to roughly 10- 15% of a pension's value. The annuity ratio is thus roughly 85%.[3]
- Transfer ratio. The transfer ratio has improved considerably in the UK, but remains relatively low. ***The Money Management*** surveys imply that the ratio for one transfer after 5 years has risen from 79% in 1994 to 89% in 1998. But even in 1996, over a quarter of the market had five-year transfer ratios below 80%.[4]

Two other aspects of the UK experience are worth noting:

- Providers have not left the market. 'The number of pension providers in the UK has not changed much over time: in 1992 there were 90 unitised personal pension plans, whereas in 1998 this number was 91.[5]
- New disclosure rules have not significantly affected average charge ratios. In 1995, the UK government introduced strict disclosure rules for personal pension costs. These rules have had surprisingly little effect on the average charge ratio, but they do seem to have reduced the ***variance*** in charges across providers (which declined by 25% between 1994 and 1997).

In summary, the UK experience provides a number of useful policy lessons for the US debate.[6] First, administrative costs are a substantial issue with private pensions, both because of charges during the accumulation and because of reductions in yield during the annuitization stage. Second, free competition over more than 10 years has not resulted in a substantial reduction in providers - the mutual structure of the industry has perhaps impeded mergers which might have exploited economies of scale to bring costs down further. Third, disclosure has had important effects in reducing the variance of charges across providers.

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[3] The actual profit loadings on annuities are quite small, and in fact ***ex post*** profits recently are negative due to better than expected male longevity.

[4] These hidden charges are particularly confusing to'consumers, because most providers claim they have no charges for transfer values. This is misleading because most providers front load their annual charges, hence imposing hidden charges on those who do not hold their accounts with the same provider for a long period of time; the difference between a fund with level charges and one that is front-loaded is captured by our transfer ratio. Such front-loading is quite significant: even in 1998, the market average ratio of one year transfer values to a fund with no charges was only 53%.

[5] Some uncompetitive life offices have shut down their pensions operations and have been replaced with nontraditional direct channel providers such as Virgin Direct, Marks & Spencer and supermarkets. But competition in the market remains strong, as evidenced by Fidelity's decision to withdraw from the personal pensions market in 1993.

[6] A more detailed investigation of UK pensions and annuities costs is currently the subject of a detailed panel data study conducted under the auspices of the World Bank by Dr. Mamta Murthi (Cambridge University), myself, and Dr. Peter Orszag (Sebago Associates, Inc.). The study is correlating charges with pension and annuity plan details and insurance accounting data, to examine in more detail the ***causes*** of relatively high costs. The study is also comparing personal pension and employer-provided pension costs, as well as examining annuity prices and cost loadings over time.

OWL is the only national grassroots membership organization to focus solely on issues unique to women as they age. OWL believes in keeping Social Security solvent. We welcome this discussion of a full range of options to strengthen Social Security because it is the foundation of women's retirement security.

Any effort to strengthen Social Security must be analyzed for its impact on women. If Social Security works well for women, providing them with adequate and guaranteed benefits, it will work for everybody. Because of their work and life patterns, women rely on Social Security for a greater share of their retirement income than men. Until the structural barriers that prohibit women from achieving retirement income parity with men are removed, we must maintain and strengthen the core of most women's retirement income, Social Security.

Women have a unique stake in this debate:

- **At age 65, women comprise 60 percent of all Social Security beneficiaries, but by age 85, they are 72 percent of all recipients.** The fastest growing cohort of population is women over the age of 85.

- **Women earn, on average, only 74 percent of what men do.** That means, for an average-waged job, they have $250,000 less in lifetime earnings at retirement than their male counterparts. They are almost twice as likely to be living in poverty as older men. Social Security represents 90 percent of income for 27 percent of older women; for 20 percent Social Security is their sole source of income.

- **The average woman spends a median 11.5 years out of the workforce, usually caregiving for children, elderly family members, or ailing spouses.** Those are years she is not paying in to Social Security, vesting in a pension, or saving in any other way for her retirement. Women are being punished in retirement for taking responsibility for their families during their prime earning years. The flexible work that allows women to be caregivers is usually low-waged, with few benefits, and because they stay in jobs an average of 3.5 years, it is difficult for them to vest in pensions, as most plans vest only after five years. Only 14 percent of women over 65 receive any income from pensions.

- **Women live an average of six years longer than men.** Life expectancy at age 65 is currently 19.2 years for women compared to 15.6 years for men. Women have smaller retirement incomes which must last for a longer period of time. Women are three times more likely to be widowed than men. Four out of five women in the 85 plus age group are widowed. As widows women are five times more likely to be poor than women who are in couple.

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OWL's principles for assessing any proposed Social Security reform to insure that it will work for women are:

1. **Social Security must remain an earned right.** Social Security is an integral component of the social insurance compact that America has made with its citizens, and must always provide equitable coverage for those who have paid for it.

2. **Social Security should be an equitable program.** Women, people with disabilities, racial and ethnic minorities, low and moderate income working people, and families must all be treated in way that will provide fair and equal outcomes today and in the future.

3. **Social Security should be genuinely gender-neutral in its outcomes.** The specific inequities faced by women, caused by their traditional employment histories and life patterns, must be specifically addressed so that women of future generations will, when they retire, receive all the benefits to which they are entitled.

4. **Social Security should provide adequacy-maintaining benefit levels for all recipients.** Any proposed benefit cuts implemented in efforts to maintain the program's solvency would disproportionately harm women and minorities; temporary, seasonal and part time workers; and the chronically under- and unemployed.

5. **All existing and new revenue sources must be explored before any changes in Social Security's structure are undertaken to assure its future solvency.** Modification of existing program fundamentals, such as the calculations of cost-of-living increases through the Consumer Price Index, changes in the retirement age, and raising the floor for the taxation of benefits; as well as ideas such as income caps, earnings sharing, taxation of unearned income, shifts in the allocation of spousal and survivor benefits, and the use of general revenues, must be carefully analyzed for their consequences for women, and their distributional impact generally, before any radical changes that could destroy the foundation of the program are proposed.

6. **Social Security must keep Americans secure. No changes should affect current recipients.** There should be no ex post facto effects of legislation on current recipients.

7. **Major changes in Social Security must not be made in isolation.** Any changes in benefits and/or revenues must be considered in the context of projected changes in Medicare, Medicaid, private retirement benefits and other aspects of the government's social insurance programs that have a profound impact on women's lives.

8. **Information on the impact of Social Security reform must be provided to the public by the Social Security Administration. Adequate funding should be provided for comprehensive public education about Social Security and any changes being proposed.** The distributional and other effects of structural reform and other proposed policy options for Social Security and other programs administered by the Social Security Administration must be analyzed and made publicly available.

VIEWPOINT ON SOCIAL SECURITY REFORM
DECEMBER 3, 1998

Parents, Families and Friends of Lesbians and Gays (PFLAG) is a national, family-oriented organization which has over 425 chapters in the United States. We represent over 70,000 members, donors and supporters. We are a non-profit, charitable and educational organization which traces its beginnings back some 25 years.

PFLAG exists in order to promote the health and well-being of gay, lesbian, bisexual and transgendered persons and their families and friends. These family members and friends have the same needs as the rest of our family members and friends. These include the needs provided for through social security -- primarily retirement, death, and disability benefits.

We who are members of PFLAG have family members and friends who are in lifetime, committed relationships. Our heterosexual members can get married and be entitled to benefits through that marital relationship. The social security benefits we enjoy through our husbands or wives provide a safety net. Where one of us has sacrificed paid employment for the sake of raising a child or in some other way providing a family benefit (by, for instance, caring for an elderly and infirm relative), we know that our social security benefits are not limited to the years we worked outside the home. Society receives a benefit from this as well, as it allows for unpaid care for those in our society who cannot care for themselves.

Those of us, however, whose lifetime commitment is to someone of the same gender, do not have access to that safety net. Social security will not provide benefits to my gay son's partner in the same way it will provide benefits to my non-gay son's wife. As a couple, my gay son and his partner will not be able to make the same choices as his brother and sister-in-law -- at least not without more serious financial sacrifices. Our government -- to which both brothers contribute through their taxes and their productive employment -- is not treating the two of them equally.

Yet I know, from first-hand observation, that good, healthy same-gender relationships share the same admirable qualities and make the same contributions to our families, our communities and our country as good, healthy opposite-gender relationships.

The core of family values is the ability to care for each other. I have seen and heard of extraordinary acts of caring by

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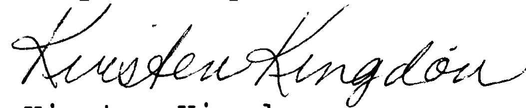
same-gender couples. Parents, siblings, nieces and nephews, abandoned and rejected children have found good, nurturing homes with same-gender couples. Often the alternative would have been institutionalized care. We ought not discourage that kind of caring. On behalf of our families, our friends and all those same-gender couples without family support, we ask that the needs of same-gender couples, and those who depend on them, not be forgotten when final decisions are made on social security reform. Please ensure that same-gender couples will have access to the same benefits as married couples.

Social security is not just about retirement and death benefits, however. It also provides disability benefits. To those unable to work because of a disability, these benefits are critical.

All too many of our member families have had to bear the terrible burden of suffering and grief which is the hallmark of AIDS. It is important that comprehensive reform of Social Security is designed so that disability benefits are available to those with disabling diseases such as AIDS and that those benefits are designed in a way which recognizes the often-unpredictable course of the disease.

Respectfully Submitted,



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COMMENTS ON SOCIAL SECURITY REFORM FOR THE WHITE HOUSE CONFERENCE ON SOCIAL SECURITY*

It is urgent that we reform Social Security and Medicare. Long-term projections by the General Accounting Office and the Congressional Budget Office suggest the possibility of a declining economy if literally nothing is done. Although Social Security poses a lesser economic problem than Medicare, it may be easier to reform, both technically and politically.

Social Security may be the most popular government program ever invented. It has greatly reduced poverty among the elderly and it has paid a very high rate of return on the payroll tax payments of past retirees.

Unfortunately, the glory days of Social Security are over. As a pay-as-you-go system, it can only pay a high rate of return to the extent that each successive cohort of workers pay more into the system than previous cohorts. In the past, each successive cohort did pay considerably more, because the size of the labor force was growing, real wages were increasing, and the average payroll tax rate was continually increased. Until recently, the most important contributor to the high rate of return was a continually increasing tax burden, as each successive generation of retirees enjoyed benefits financed by taxes on workers that were much higher than the retirees had faced during their own working lives.

It is implausible to think that we can continually increase future payroll tax burdens and there will be little growth in the labor force in the period 2010 to 2030. For both reasons, rates of return to future retirees will be very low, and without reform, the system is likely to lose political support in the very long run.

It is necessary to move from a pay-as-you-go to a funded retirement system to avoid this outcome. I believe that the safest way to accomplish this goal is through a system of mandated individual accounts that would complement a slimmed-down Social Security system.

Some worry that individual accounts will involve transaction costs that are too high and thus will greatly reduce the rates of return available to individuals. Even under the worst assumptions, the rates of return on individual accounts are likely to be higher for most than the rates provided by traditional Social Security. But if high transaction costs are a concern, the National Commission on Retirement Policy (NCRP), of which I was a part, has shown that transaction costs can be reduced to insignificant levels by having the information and collection process administered by the Social Security Administration and by limiting the number of investment options for the individual and the number of trades allowed each year.

Others worry that individual accounts impose too high a risk on investors. Data on IRAs and 401ks suggest that investors are quite modest in their risk taking, especially as they near retirement. If, however, risk is a major concern, plans by Senator Gramm and Martin Feldstein show that much of the risk can be left with the government by having traditional Social Security benefits make up for a part of any earnings disappointments from individual accounts. Alternatively, a minimum benefit can be guaranteed that is higher than the current minimum from Social Security. Although I prefer not to have the government left with a large, implied, contingent liability, I can see moving in this direction as a compromise. In any case, an approach that shares risk is much superior to plans that would have the trust fund invest in equities, in which case, the government bears the entire risk of market fluctuations.

There are many available options for reducing the future growth of Social Security benefits. One can do it through explicit reforms, such as increasing normal and early retirement ages, or one can, as in the Gramm/Feldstein proposal, reduce the Social Security benefit by an amount linked to the investor's success with his or her individual account. The latter guarantees that no one has to do worse than under the current Social Security system. That may give the plan a major political advantage, but it misses the opportunity to make the structure of Social Security more equitable and more conducive to encouraging later retirement.

One of the most prominent competitors with individual accounts is the notion that the trust fund should invest in equities. I find this approach highly troubling. It is scary to think of the political temptations posed by the government owning trillions of dollars of corporate equity. Proponents say that they will avoid this danger by organizing the management of this fund like the Federal Reserve System. That is not reassuring, since the Federal Reserve has been accused of bowing to political pressure in the past, most notably when Chairman Arthur Bums was rightly or wrongly accused of pumping up the money supply on behalf of Richard Nixon's re-election.

Proponents of equity investments by the trust fund also suggest that government can more easily spread risk among the generations. If so, this is also a characteristic of the Gramm/Feldstein approach which leaves much of the risk with the government. But there is absolutely no reason to believe that government would spread risk in an equitable manner. More likely, the strongest political incentive would be to distribute the benefits of positive market surprises immediately by raising benefits or cutting taxes while delaying the pain of negative surprises until future generations.

If we move to individual accounts, it is important to ask how they will be financed. Will the mandate be imposed on top of the current payroll tax system or will payroll or other taxes be cut to offset the pain imposed by mandates? The latter approach could be characterized as using the surplus to save Social Security. I would like to keep a significant budget surplus to supplement the deplorably low level of current private saving. However, this is likely to be an unrealistic goal given the long list of demands for tax cuts and spending increases lurking in the background. Using the surplus to facilitate individual accounts represents a much better use of the money than virtually all the other items on the list.

*The views expressed in this piece are those of the author and do not necessarily represent the views of the trustees and employees of the Urban Institute.

The Blackstone Group

Clearing the Air of Fictions

Peter G. **Peterson**
Chairman

Each day Americans are becoming better versed in all the problems, from generational inequity to declining trust in government, that call for big changes in Social Security. Yet many defenders of the status quo still claim there's nothing wrong with Social Security that a few minor changes won't fix. Let's take their fictions from the top one more time.

Fiction: Social Security can pay all promised benefits until the year 2032. This most common of status-quoist fictions contains a kernel of fact: The Trustees now project that Social Security will be "solvent" until the year 2032—meaning that its trust funds will possess sufficient assets, and hence budget authority, to cover benefits until that date.

The problem is that the trust funds are a mere accounting device. Social Security's stored-up assets consist of nothing but a stack of Treasury IOUs that can only be redeemed if Congress raises taxes, cuts other spending, or borrows from the public. Thus, their existence doesn't ease the burden of paying out future benefits. What really matters is the program's operating balance-that is, the annual difference between its outlays and earmarked tax revenues. Social Security's current operating surplus is due to begin falling in 2002 and turn into an operating deficit in 2013. This deficit will widen to an annual cash shortfall of $734 billion by 203 1, the last full year the trust funds are projected to be "solvent."

Fiction: A 'mere" 2.2 percent of payroll tax hike would solve Social Security's fiscal problems. In theory, 2.2 percent of payroll is the amount that Congress would have to raise taxes or cut benefits, starting today, to bring the trust funds into balance over the next seventy-five years. Status quoists routinely trot out this number as evidence of how small the Social Security problem is. As economist Henry Aaron asks, how can anyone talk about a "crisis" that could be solved by a mere 2.2 percent of payroll tax hike?

Let us explain. The new assets that the trust funds would accumulate due to this tax hike would be no more real than the old assets. All the 2.2 percent solution would accomplish is to postpone Social Security's first operating deficit by seven years-from 2013 to 2020. After that, the trust funds would only remain solvent by cashing in an even larger mountain of paper IOUs.

Fiction: The economy is bound to grow faster than projected-erasing Social Security's deficit. A close reading of the official projections reveals a big disparity between historical rates of real GDP growth (2.6 percent annually since 1980) and the Trustees' long-term assumption (just 1.3 percent annually by the 2020s). With the current expansion still in high gear, some status quoists, including former Labor Secretary Robert Reich, conclude that there must be some kind of mistake. Suppose, they argue, that the economy keeps growing at its historical rate. Wouldn't this be enough to close Social Security's long-term deficit?

But the mistake is theirs, not the Trustees'. When the Trustees project that real GDP growth will eventually slow to 1.3 percent per year, they aren't assuming any decline in the

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growth rate of product per worker. The entire fall in GDP growth is due to the slowdown in workforce growth as Boomers retire-from 1.5 percent annually since 1980 to just 0.1 percent during the 2020s. The status quoists need to wake up to demographic reality. Maintaining America's historical rate of GDP growth would require more than doubling productivity growth to 2.5 percent. As for erasing Social Security's long-term deficit, it would require tripling productivity growth to 3.0 percent-a rate never before equaled over an entire business cycle.

Fiction: Social Security alone won't endanger the economy. The rising total cost burden of just the major senior benefit programs-Social Security, both parts of Medicare, and Medicaid for the elderly-is projected to reach 35 percent of payroll by 2040. Clearly this is unsustainable. Yet many senior groups refuse to confront this cost in its totality. Instead, they argue that each program should be regarded as a separate "deal'‘-regardless of whatever else is going on fiscally and economically. From this perspective, Social Security is "affordable."

This is like telling a homeowner that no single rock matters in the landslide that buries his family. Yes, the status quoists are right that Social Security is not growing as fast as Medicare or Medicaid. But it is the very intractability of health-care cost growth that makes achieving savings in Social Security so urgent. This point is lost on the status quoists, who apparently believe that future workers won't mind paying a stupefying total tax burden so long as many different federal agencies are collecting and spending the money.

Fiction: The official projections are pessimistic. Another frequently heard claim is that the official cost projections are based on unduly pessimistic economic and demographic assumptions-and should therefore be regarded as a worst-case scenario. Columnist Robert Kuttner, for instance, calls the Trustees' projections "too gloomy."

The status quoists have it backwards. Far from being pessimistic, the Trustees' "intermediate" scenario is based on assumptions that are surprisingly optimistic given the trends of the past twenty-five years. According to this scenario, productivity growth will speed up by 20 percent; growth in life expectancy at age sixty-five will slow by 60 percent (shorter life spans brighten Social Security's fiscal outlook); and the annual growth in real per beneficiary health spending will slow from 5 percent to just 1 percent. What happens if the future is more like the past? Take a look at the Trustees' "high-cost" scenario, in which Social Security faces a trust-fund deficit of 5.4 percent of payroll (not 2.2 percent)-and the total cost of the major senior benefit programs rises to 55 percent of payroll (not 35 percent).

Fiction: Even after paying for senior benefits, the next generation will still enjoy a rising living standard. Won't the next generation be better off? And if so, won't they be able to pay taxes at higher rates and still take home more income? Columnist Michael Kinsley writes of Social Security: "Even if it amounts to... an even larger transfer from future workers to future retirees, so what? The younger generation will still be richer than the older one, even after the transfer takes place."

Let's leave aside the principle implicit in this argument-that we have a right to cash out and pocket our children's economic progress. The argument is factually incorrect if we take into account the total burden of young to old transfers. Raising taxes enough to pay for the growing cost of the major senior benefit programs would, under the Trustees' official scenario, erase all growth in real after-tax worker earnings over the next half century. Under the high-cost scenario, earnings would suffer a large decline. It's easy to say America would never allow this to happen. But that begs the question of how we will change course and when.

Chile's Social Security Lesson For The U.S.

by Jose Piñera

America's Social Security system will go bust in 20 13. As political leaders scramble to save it, they've overlooked an obvious free-market solution that works. They need only look at Chile.

Pay-as-you-go social security systems destroy the link between contributions and benefits, between effort and reward. Everyone tries to minimize what he puts into the system while trying to maximize through political pressure what he can get out of it. That's why pay-as-you-go plans are going bankrupt all over the world.

Chile faced that problem in the late 1970s. As secretary of labor and social security, I could have postponed the crisis by playing at the edges, increasing payroll taxes a little and slashing benefits a little. But instead of making some cosmetic adjustments, I decided to undertake a structural reform that would solve the problem once and for all.

We decided to save the idea of a retirement plan by basing it on a completely different concept -- one that links benefits and contributions. Chile allowed every worker to choose whether to stay in the state-run, pay-as-you-go social security system or to put the whole payroll tax into an individual retirement account. For the first time in history we have allowed the common worker to benefit from one of the most powerful forces on earth: compound interest.

Some 93% of Chilean workers chose the new system. They trust the private sector and prefer market risk to political risk. If you invest money in the market, it could go up or down. Over a 40-year period, though, a diversified portfolio will have very low risk and provide a positive rate of real return. But when the government runs the pension system, it can slash benefits at any time.

The Chilean system is run completely by private companies. We now have 12 mutual funds competing for workers' savings.

We guaranteed benefits for the elderly -- we told those people who had already retired that they had nothing to fear from this reform. We also told people entering the labor force for the first time that they had to go to the new system.

Today, all workers in Chile are capitalists, because their money is invested in the stock market. And they also understand that if government tomorrow were to create the conditions for inflation, they would be damaged because some of the money is also invested in bonds -- around 60%. So the whole working population of Chile has a vested interest in sound economic policies and a pro-market, pro-private-enterprise environment.

There have been enormous external benefits: the savings rate of Chile was 10% of gross national product traditionally. It has gone up to 27% of GNP. The payroll tax in Chile is zero. Of course we have an estate tax and an income tax, but not a payroll tax. With full employment and a 27% savings rate, the rate of growth of the Chilean economy has doubled.

That does not mean that we do not have any problems in Chile, but I believe that a society based on individual freedoms -- economic, social and political -- is a much more prosperous and lively society.

Could something like this be done in the U.S.? People have said it's utopian and that nobody in the establishment would support privatization, but I believe the situation is changing.

Recently, I was invited by Sen. Phil Gramm, R-Texas, to testify before the Senate Subcommittee on Securities. Basically, everyone agreed that a system like this is much more consistent with American values than a system created by a Prussian chancellor in the 19th century.

Of course, that does not mean that the reform will be done in the next month or the next year. I believe there's still a lot of education yet to go. But there's also a great opportunity here, and I think it's a very responsible thing to give your children and grandchildren.

Jose Piñera is Chile's former secretary of labor and social security and is co-chairman of the Cato Institute's Project on Social Security Privatization. (This article originally appeared in ***Investor's Business Daily.***)

The Strengths of Social Security and
the Best Course of Action for Preserving this System

Wendell Primus
Director of Income Security
The Center on Budget and Policy Priorities

Social Security has unquestionably been our nation's most successful social program. As such, great care must be taken to ensure that the achievements of this program are continued and any reforms taken to address the long-term actuarial imbalance do not undermine the strengths of this system.

The Success of Social Security. Social Security is largely responsible for the dramatic reduction in poverty among elderly people. Half of the population aged 65 and older would be poor if not for Social Security and other government programs. Social Security alone lifted 11.4 million seniors out of poverty in 1997, reducing the elderly poverty rate from about 48 percent to about 12 percent.

Social Security payments provide the majority of the income of poor and near poor elders. In 1995, Social Security payments constituted two-thirds of the total income of the elderly poor. Some 96 percent of seniors with incomes just above the poverty line received Social Security payments in 1994. This program is the major source of income for 66 percent of beneficiaries age 65 or older, and it contributes 90 percent or more of income for about 33 percent of these individuals.

Social Security is designed with protections that are especially important to low-income seniors. The benefit formula is progressive and provides low-wage workers with proportionally larger benefits in relation to their pre-retirement earnings. Additionally, benefits are automatically adjusted each year for inflation, which prevents erosion in the buying power of benefits.

Finally, Social Security is a comprehensive insurance system that provides important benefits in the event of death or disability. Approximately one third of all beneficiaries receive disability or survivors benefits. One in six people age 20 today will die before retirement and about three in ten will become disabled. Clearly, Social Security is an essential program for workers of all ages. Moreover, Social Security is essential to dependents of workers. The program is also responsible for removing 4.6 million nonelderly individuals, including one million children, from poverty in 1997.

Preserving Social Security for the Future. In light of the importance of Social Security to workers and their families, actions taken to address the long-term imbalance in Social Security must not undermine the achievements of the system. One option is to invest a portion of the trust funds in the private market through an independent governing board. This would increase the rate of return on this portion of the assets and make the treatment of Social Security assets comparable to the treatment of private pension funds. Furthermore, investing the trust funds would achieve the same rate of return as individual accounts without exposing workers to market risk or incurring the transition costs, annuity costs, or administrative costs of establishing 150 million individual accounts (see "The Shortcomings of Individual Accounts" by Kilolo Kijakazi of the Center on Budget and Policy Priorities). The investment decisions would be isolated from political influence by:

- appointing an independent governing board, set up like the Federal Reserve Board, to manage the funds;
- appointing an independent executive director of the board;
- selecting a portfolio manager through a competitive bidding process to invest the funds;
- requiring the portfolio manager to passively invest in broadly indexed funds with the level of investment set by statute; and
- prohibiting board members from voting stock.

The Social Security Administration actuaries estimate the long-term imbalance of 2.19 percent of payroll can be reduced to 0.97 percent of payroll if 50 percent of the trust funds is invested in equities.

The savings achieved by investing the trust funds in equities would lower the benefit reductions or tax increases needed to restore the long-term balance. Another option would be to measure price changes more accurately. Providing the Bureau of Labor Statistics (BLS) funds to update the market basket used in the Consumer Price Index (CPI) at least every five years and incorporating corrections to the CPI already announced by BLS will reduce the long-term deficit by about 0.45 percent of taxable payroll.

The remaining amount could be eliminated by modest increases in revenues or benefit reductions. Modest reductions in benefits on a prospective basis should be considered to close the gap. The most attractive revenue options are to increase the earnings base subject to taxation and to add all newly hired uncovered state and local employees to the Social Security system.

Conclusion. The strengths of the Social Security system can be preserved for future workers by investing the trust funds in the private market to increase the rate of return to assets without individual risk, transaction costs or administrative costs. Then modest program changes could be implemented to eliminate the remaining shortfall.

President
George J. Kourpias
Executive Director
Steve Protulis

National Council of Senior Citizens

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The Social Security Tax Cap Secret
Steve Protulis, Executive Director
National Council of Senior Citizens

Advocates of Social Security privatization are working hard to convince the American people that Social Security is in deep trouble, and that the only solution is to transform the current social insurance system into a privatized system based on hundreds of millions of individual stock market accounts.

What privatization proponents consistently fail to mention, however, are the dangers inherent to their proposed solutions and the enormous gains to be had by simply raising the Social Security tax cap.

The True Scope of the Problem

You wouldn't know it to listen to some pundits and politicians, but Social Security's problems are quite modest, if they exist at all. Current concerns over Social Security's long-term financing are based on the assumption that the U.S. Gross Domestic Product will average only 1.5 percent annual growth over the next 75 years. The problem is that the United States has never sustained such low GDP growth outside of the first four years of the Great Depression. To put it another way: the notion that Social Security is "going to go broke" around 2032 is based on the idea that the United States will suffer a decades-long economic depression!

In fact the U.S. economy is roaring along-an uncomfortable reality for privatization proponents-and one they largely ignore. If we assume that the U.S. economy will grow at only 2.5 percent per year (less than the 3.21 -percent GDP growth the U.S. has averaged over the last 50 years), Social Security will never go broke!

A Shrinking Problem

Earlier this year, the Bureau of Labor Statistics made technical (and therefore noncontroversial) adjustments to the Consumer Price Index used to calculate Social Security's annual Cost of Living Adjustment or COLA. The result of this change to the CPI formula is that early next year the Social Security Trustees will report that Social Security's long-term actuarial deficit is 18 percent less than it was just one year ago.

The Dangers of Privatization

Prudent Americans will argue that we should err on the side of caution and make whatever changes are necessary to prevent the remote possibility of a long-term shortfall in the Social Security Trust fund. We agree.

Long-term shortfalls, however, are normally traversed by making small steps, not taking giant leaps of faith such as those advocated by privatization proponents. In fact, radical privatization schemes carry enormous costs and substantial risks.

Perhaps the greatest risk is that scores of millions of gullible Americans will be lured into risky stock market ventures by the siren-song of unscrupulous Wall Street traders. While Wall Street dangles the lure of "minimum-wage millionaires" before a gullible public, the only guarantee they

offer is that they themselves will collect hefty management fees whether the market rises or falls. Those fees-estimated at $240 billion over 12 years-provide ample motivation for Wall Street to fund organizations willing to flack privatization schemes.

Nor is privatization a free lunch. Because old Social Security obligations will have to be paid, even as new Social Security revenues are being diverted into private accounts, taxes will have to be increased by 3 percent of taxable payroll for 35 years in order to fund a transition to a privatized system. Ironically, this payroll tax increase is larger than that needed to satisfy the long-term Social Security shortfall we now have-estimated to be 2.19 percent of taxable payroll. In short, simply increasing Social Security payroll taxes 1.1 percent on both the employer's side and the employee's side is both less costly and less risky than privatization.

The Tax Cap Secret

There is a simple way to solve the so-called "Social Security crisis" that does not involve cutting benefits, spending trillions of dollars in transition costs, or asking 130 million Americans to speculate in the stock market. It involves raising the Social Security tax cap.

The secret of the rich and powerful is that most of them stop paying Social Security taxes before the end of the year. Under current law, all Social Security taxes for the year stop after an individual crosses the salary income threshold of $68,400 (for 1998). No other tax stops altogether when you make more money-not even Medicare.

The result is that a worker earning $35,000 a year pays Social Security taxes all year long while his boss-making $140,000 a year—stops paying Social Security taxes by the first of July and gets a 6 percent raise for the rest of the year!

Opponents of raising the Social Security tax cap make three arguments. The first two are that it would be "unfair" to raise the cap without raising benefits, and that raising the Social Security tax cap would garner too much opposition in Congress.

Nonsense.

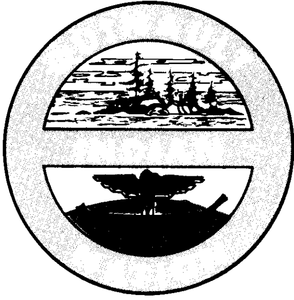
In 1993, the Medicare tax cap was completely eliminated without increasing benefits at all. Not only was the change politically palatable, it was accomplished with only the barest notice or comment! This is not to say that raising Social Security benefits for the well-to-do could not be accommodated in conjunction with elimination of the tax cap. In fact, such a compromise is possible by simply adjusting the current Social Security benefit formula.

The third argument-that raising the Social Security tax cap doesn't raise enough money-is perhaps the easiest to refute. The Social Security Administration calculates that if the Social Security tax cap were eliminated entirely (as was done for Medicare) **Social Security could remain solvent forever** after factoring in the changes to the CPI previously mentioned. If a more modest change was made, and the Social Security taxable base cap was removed on the employer's side alone, and the CPI changes were also made, almost 70 percent of Social Security's long-term actuarial deficit would disappear.. . . That is, if there is a deficit at all.

The Bottom Line

Ironically, as political momentum for a "tax cap solution" begins to gain momentum, the barons of Wall Street may decide there's no Social Security "crisis" after all. Wall Street is hoping to raise support for mandatory private investment in stock and bonds. The last thing Wall Street's wealthy want is to be asked to do their duty to keep the national social insurance system solvent.

In the Social Security debate, as in so many others, where you stand on the issue may depend on where you sit. And if the past is prologue, Wall Street's wealthy intend to sit on their wallet. It's a plan of attack the rest of us might do well to follow.



Quinault Indian Nation

POST OFFICE BOX 189 □ TAHOLAH, WASHINGTON 98587 □ TELEPHONE (360)276-8211

To: The White House Conference on Social Security
From: James DeLaCruz, Senior Program Manager, Quinault Indian Nation
National Congress of American Indian s Sub-Committee
Chair on Elders Issues

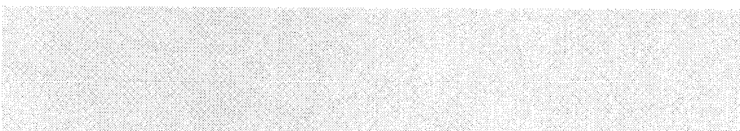
Date: 12/0 1/98

Re: Social Security

The following statement was submitted from the National Indian Council on Aging to the National Congress of American Indians Sub-Committee. This resolution was passed and approved.

SOCIAL SECURITY CONCERNS

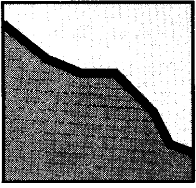
- Elders are concerned that the amount being earned by the Social Security Trust fund may not be as much as it could be and question whether the funds are being invested properly. Some elders want the government to take a "hands-off" policy with respect to the Social Security trust fund.
- Elders are concerned that if there is privatization of Social Security, will the Trust fund be depleted more rapidly?
- There is a need to establish Social Security officers on reservations to overcome language barriers and ensure that elders have improved access to services to which they are entitled.
- Direct deposit does not work for many Indian elders because of their lack of access to banking facilities.
- Elders state that all workers should participate in the Social Security system to ensure the original intent of the system.
- Some elders are concerned that they are being penalized for the benefits they receive from railroad pensions.



- Some elders are concerned that when they receive military pensions, there is a reduction to their Social Security benefits.
- Some elders are concerned about the limit they can contribute to 401 -K plans.
- Some elders question why their Social Security benefits are terminated because of earnings by their spouses.
- Some elders question why, when working in government civil service positions, they were not able to pay into Social Security and were hence not eligible for Social Security benefits.
- Elders want to know about the changes to Medicare and Medicaid.
- Elders do not want cuts to Medicare.
- Some elders are concerned that Social Security is going bankrupt.
- Elders expressed a need for education and information to help them choose between retirement plans.
- Elders need information on applying for HMO coverage.
- Elders wonder why they have had deductions for Medicare but do not receive benefits.
- Elders need information on investments for future generations since young people have lost faith in Social Security.

SOCIAL SECURITY RECOMMENDATIONS

- Advocate for establishment of Social Security offices on reservations to overcome language barriers and ensure that elders have improved access to services to which they are entitled.
- Through existing organizations in the community, conduct educational programs on Social Security and related issues to clarify eligibility and benefits and to improve access to qualified beneficiaries.
- Ensure that educational programs and Social Security offices are sensitive to the specific needs of Indian elders and that interactions with elders are conducted in ways consistent with Indian language and culture.



Retirement Security Alliance

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White House Conference on Social Security -- December 8, 1998

Retirement Security Alliance
Organizational Statement on Social Security Reform

Over the past year, President Bill Clinton has led the nation in a debate on the future of Social Security. Prior to the 1998 State of the Union, dozens of organizations and a handful of Members of Congress were working to publicize the need to reform Social Security sooner rather than later. However, over the past year, and largely because of the President's call to find a solution to Social Security's long term solvency challenges, scores of additional organizations and companies have become involved in this debate.

Throughout Washington and across the country, Social Security is a topic of conversation at political events and in corporate board rooms. On Capitol Hill, several pieces of legislation to reform Social Security have been proposed and several more are currently being drafted. However, finding a solution that can get the sufficient bipartisan support necessary to be implemented into law will require more interest from Members of Congress and the involvement of hundreds of more companies and organizations.

In an effort to help the Social Security debate move more rapidly toward reform, The Retirement Security Alliance has worked to build a coalition of organizations who are committed to the following principles:

- Concern about the looming crisis in retirement financing, particularly in Social Security, and the low national savings rate.
- Debate should extend beyond the traditional approaches of raising taxes and cutting benefits, including options that give Americans more choice and control over their Social Security contributions.
- Extensive public education on the issue of Social Security reform. Certainly this education must continue throughout the legislative process.
- Increased public activism in support of timely Social Security reform, with a target of reform legislation being adopted in 1999.
- A secure retirement for current and future retirees.

While everyone must work to engage more Members of Congress, organizations, and companies with the Social Security debate, we are at a unique moment where those involved and those contemplating involvement need to see a higher degree of bipartisanship than currently exists. Both parties need to adapt their efforts to secure the goal of increased bipartisanship. Increased bipartisanship is especially critical if more companies are to become involved with the debate. Corporate America will be more comfortable discussing the future of Social Security if they witness less political partisanship and less demagoguery that includes inaccurate and inflated statements from both sides of the debate.

With a few exceptions on both sides of the political aisle, there is no question that an environment of bipartisanship does not currently exist.

Another goal of the Retirement Security Alliance and its scores of members and friends is to begin a dialogue on the costs associated with both preservation of the status quo as well as all reform options being seriously considered. Without question, the White House Conference on Social Security and the subsequent legislative process in 1999 can be the catalyst for this discussion.

In poll after poll, there is apprehension about any form of payroll tax increase, concern about increasing our nation's debt, and most proposed benefit reductions. Public education has to be enhanced so that people understand that doing nothing is not an option and that whatever path Social Security takes in the future will mandate a price to be paid at some level. Until the public understands this reality, decision makers in Washington are going to be tepid in their involvement of the discussion of costs for the future of Social Security.

To realize the above goals, perhaps decision makers in Congress should ask themselves the following questions, and make their thoughts known to the public.

- Does the President think that reform is possible without stating his position on issues such as raising the retirement age, personal accounts, how to pay for current social security liabilities and other questions he has asked others, during the past year of dialogue?

- Do both political parties truly believe that their current actions are maximizing the level of bipartisanship necessary to solve the long term solvency challenges facing Social Security?

- If members of both parties could pick just one legislative initiative, which would it be: Tax cuts or Social Security reform?

- If we don't get Social Security reform in 1999, what is the next window of opportunity considering election year politics and the inevitability of a first-term president in 2001?

There are many other questions that need to be addressed. But the White House Conference seems to be the best venue to begin getting some answers.