TESTIMONY

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON

SOCIAL SECURITY SOLVENCY

OCTOBER 3, 2002
WASHINGTON, DC

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AARP appreciates the opportunity to present its views regarding proposals to strengthen Social Security over the long-term. Concern about Social Security's long-term financial health has prompted a variety of solvency recommendations from legislators, presidential commissions, and policy analysts. In addition to solvency measures, many recommendations include proposals to establish individual accounts either instead of or in addition to Social Security's basic guaranteed benefit. Improving Social Security's long-term financial health is essential. We believe it must be accomplished in a prudent and bipartisan manner that both maintains the program's critical income protections for current and future beneficiaries and fits into the overall framework of retirement security, which includes policies supporting broaden pension coverage and more opportunities for older workers. Any changes must also command the support of the public.

Social Security's income protection for Americans of all ages is unmatched. It is the primary income source for the overwhelming majority of older Americans, and Social Security keeps nearly half of older Americans out of poverty. The program also provides insurance protection against disability and death for nearly all working Americans and their families. Once benefits begin, they are indexed annually for inflation and are guaranteed for a lifetime. Social Security remains the most dependable of the four pillars of a secure retirement. (The remaining three pillars are savings and pensions, earnings, and health insurance.)

According to the 2002 trustees' report, Social Security has sufficient assets to continue paying full benefits on time until 2041 and over seventy percent of benefits for decades thereafter. Some changes to Social Security will be necessary to enable the program to continue as the solid

foundation of retirement income security. The sooner modifications become law, the more modest they can be and the longer those affected will have to adjust their plans.

Historically, Social Security financing shortfalls have been corrected through a balance of benefit reductions and revenue increases. Examples of benefit cuts include increasing the age for collecting full retirement benefits, modifying the benefit formula, and delaying or reducing cost of living adjustments. Additional Social Security revenue could be generated by, for example, requiring the participation of all newly hired state and local workers not covered by Social Security or by a modest increase in the level of wages subject to the payroll tax.

Since many traditional solvency options lack widespread popular support, interest has grown in diversifying Social Security's investments --either collectively or through individual accounts. This approach could lessen the degree of benefit cuts or payroll tax increases needed to restore long-term solvency provided individual accounts were not financed with current payroll tax revenue.

By law, Social Security can invest only in special interest Treasury securities and certain government-backed debt instruments. Some would increase the potential return on trust fund investments by broadening the range of permissible trust fund investments to include other government-backed securities. Others prefer to let Social Security, similar to the practice for pension plans, hire professional money managers to invest a portion of the trust funds in a more diversified portfolio, including stocks and bonds. Collective investment in the private market could increase the return to the trust funds and spread the risk among workers and across

generations. Collective investment would also have much lower administrative and management compared to individual investment accounts for 150 million workers.

Opponents argue that broader trust fund investments could interject politics into the investment decision-making process, could interfere with economic and market performance, and potentially place too much government oversight in the corporate boardroom. AARP believes greater diversification can be accomplished, by fiduciaries on behalf of the trust funds, without such negative consequences. In particular, AARP supports investment of Social Security reserves in other government-backed securities.

AARP also believes that individual retirement savings accounts can and should be an important component of an overall national retirement income policy. However, AARP believes individual accounts should supplement, not supplant, Social Security's defined benefit promise. Substituting individual accounts for all or part of Social Security would worsen Social Security's solvency and shift to the individual a larger portion of risk, thus jeopardizing the nation's near 70-year commitment to assure retirement, disability, and survivor benefits for eligible workers and their families.

Individual investment accounts financed with current payroll tax dollars ("carve-outs"), such as those recommended by the President's Commission to Strengthen Social Security, worsen Social Security's long-term financial outlook by diverting revenue needed to pay currently- promised benefits into individual accounts. The greater the percentage of payroll tax dollars siphoned off,

the larger the loss to the trust funds. A further decline in Social Security's long-term financial outlook would hasten the need for benefit reductions and/or higher taxes to restore solvency.

Individual accounts that substitute, in whole or in part, for Social Security would gradually move the program from a defined benefit plan toward a non-guaranteed, defined contribution, or individual savings plan. Social Security's base of income protection --augmented by pensions and private savings (and possibly earnings)--would become less predictable. Indeed, the distinction between Social Security and the pension and savings pillar of retirement income would be blurred, and the different purpose of each could be lost. Currently, the systems are complementary, with the guaranteed lifetime benefit of Social Security providing a secure foundation for individuals to invest and take on risk elsewhere. Over the past two decades, the private sector has seen trillions of dollars moved into individual retirement arrangements, either through IRA's or pension plans such as 401(k) plans. In fact, all individuals currently have a tax-favored personal retirement account vehicle available to them. We should work to increase access to and use of such accounts, but not at the expense of Social Security. Adding to current retirement savings is necessary especially for lower wage workers if we are to improve overall retirement security.

Individual investment accounts financed within Social Security would not only reduce Social Security's guaranteed lifetime benefit, but it could weaken the special protection for low earners provided by Social Security's progressive benefit formula. Social Security benefits represent a larger portion of low-wage workers' pre-retirement earnings than for average and high earners. If workers contribute the same percentage of payroll taxes to individual accounts, then higher

earners would have more to invest, with potentially greater returns. Yet, the size of the Social Security trust funds would be smaller and less revenue would be available to support the progressive benefit structure.

Many low-income workers are members of ethnic minority groups and/or women. Each group would face additional problems if Social Security individual investment accounts are financed with existing payroll tax dollars. Social Security is critical to women's financial security because they live longer and depend on benefits for a larger share of their retirement income. Women benefit from Social Security's lifetime guarantee, which, unlike investment accounts, cannot be outlived. Moreover, Social Security benefits are adjusted annually for inflation in order to help keep pace with the rising costs of goods and services. This adjustment helps prevent beneficiaries from becoming poorer when they are older and more likely to have higher medical costs and fewer assets. Both the lifetime guarantee and annual inflation adjustments are rarely available with individual investment accounts.

Social Security's critics have often asserted that minority populations would benefit from having a portion of their payroll tax dollars diverted to individual investment accounts rather than remaining in the trust funds to help finance a guaranteed Social Security benefit. They are wrong. The critics are quick to point out that some African American workers die before reaching retirement age, but conveniently overlook the value of disability and survivor benefits for them and their families. African Americans represent 12 percent of the population, but make up 18 percent of workers receiving Social Security disability benefits; their children represent

21 percent of those who receive benefits as the child of a disabled worker. In addition, a large percentage of low-income minority populations benefit from Social Security's progressive benefit formula.

Hispanic workers and beneficiaries have much to lose as well. Since the Hispanic population is disproportionately younger than other ethnic groups, they would be hard hit by having to pay for benefits under the old system while funding a new system for themselves. Additionally, Hispanic elders tend to be longer lived than other beneficiaries and are advantaged by the fact that Social Security is guaranteed for life and adjusted annually for inflation.

Carve-out individual accounts also jeopardize Social Security's disability protection. Approximately 6.7 million people receive disability benefits as a worker or a dependent. Young workers who become disabled could receive a smaller lifetime benefit for themselves and their dependents since they might not have enough time to build up their accounts and cannot contribute once they withdraw from the labor force. Some comprehensive individual account proposals, such as those suggested by the President's Commission to Strengthen Social Security, claim to preserve the disability program but do not maintain the same level of benefits provided under current law.

In addition to weakening Social Security's protections for vulnerable groups, individual accounts pose additional problems. The high rates of return supporters promise may be lower than expected. As the Congressional Budget Office (CBO) points out, rates of return analyses overlook differences in risk. Corporate stocks can yield a higher return than government bonds,

but they carry a higher risk. On a risk adjusted basis, investing in government bond provides the same return as investing in corporate stock. Furthermore, this "money's worth" analysis overlooks the fact that in a pay-as-you-go system, the first generation of retirees always receives a higher return compared to future generations. This does not reflect any inefficiency on Social Security's part; rather it reflects the nature of a pay-as-you-go system. Raising the rate of return for current generations of workers can be done only by lowering the returns for future generations. ("Social Security: A Primer," Congressional Budget Office, p.58)

Rate of return analyses assume a worker has a steady stream of contributions over a working life. However, many workers have periods of unemployment or reduced earnings. Social Security protects these workers by providing "dropout years." (The Social Security benefit formula assumes a forty-year work history, but calculates the worker's benefit on the thirty-five highest earning years, thus allowing five "drop-out" years). Additionally, investors remain at the mercy of stock or bond price volatility, particularly as they approach retirement (as illustrated by the most recent "adjustment" in the market). Some analysts question whether the projected value of a portfolio will materialize when the boomers reach retirement. At that point, a large group of retirees may begin to sell their assets, and public and private retirement programs may also need to sell holdings to finance their benefit commitments. Some have speculated that this simultaneous unloading of assets could drive down the value of the investments in workers' accounts.

Individual account supporters insist that these vehicles will promote additional retirement savings. CBO points out that the impact on national savings depends on the details of the proposal and on how the government and individuals respond. When individuals save more, they must forego current consumption, not reallocate their existing assets. If individuals save more, government action elsewhere could offset this, thereby leaving the national savings rate unchanged.

To help future generations attain a more financially secure retirement, many have proposed establishing supplemental individual savings accounts at the same time that we work toward securing Social Security's long-term solvency. These accounts could be in addition to or an extension of individual retirement accounts, 401(k) plans and other savings opportunities already available and could be targeted to low- and moderate-income workers who find it most difficult to save. Others suggest that in order to make saving easy, everyone be provided access to supplemental accounts through payroll deductions. AARP supports such an "add-on" approach. These supplemental accounts could have various designs. Ideally, such accounts would include professional management, be easy and inexpensive to administer, and offer workers incentives to save.

Since many low-income workers have little, if any, discretionary income, added incentives may be necessary to attract them to participate in supplemental retirement accounts. For example, the recently enacted tax credit for lower wage workers - which in effect works as a government match for some - could be expanded.

Americans of all ages should become better informed about the Social Security system so they can participate in the debate about its role in their future. AARP is committed to contributing to this public information effort. The program has been, and should continue to be, an important part of our nation's commitment to providing income protection for workers and their families against the financial difficulties many would face as a result of a wage earner's retirement, death or disability.

Maintaining Social Security's long-term solvency and improving the overall retirement income of future generations are vital to our nation's economic well-being. Fortunately, we have the opportunity to engage in a meaningful national dialogue that will lead toward informed judgment and consensus about the best way to strengthen the program for the long term.

The Association looks forward to participating on a bipartisan basis with our nation's elected officials to achieve a solution to strengthen Social Security for the future. This solution should maintain the program's guiding social insurance principles, ensure benefit adequacy, and achieve solvency in a fair and timely manner. Social Security must continue its role as the foundation of lifetime income security for tomorrow's beneficiaries.