Testimony on “Banking on Retirement Security”

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Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. The question of whether to establish individual accounts in Social Security is a contentious one. I want to begin my testimony by making a few points that everyone – whether they support or oppose accounts – generally agrees with. I will then go on to explain why I believe replacing a portion of Social Security with individual accounts would be a mistake.

***First, if accounts are established, they should not include a bank option*.**

No individual account proposal scored by the Social Security actuaries in the last several years includes a “bank option.” There are two principal reasons for this:

First, accounts proposals all include a Treasury bond option. This is the safest security there is (although guaranteed to lose money, as I explain below). There is no financial reason to supplement this with an additional bank option. Bank accounts – including CDs – provide a higher degree of liquidity in exchange for a lower rate of return. The additional liquidity provides no additional benefit for retirement savings which often are not needed for several decades.

Second, and more fundamentally, the additional monitoring and enforcement costs associated with a bank option would be prohibitively expensive compared to the current design of Social Security proposals. Every plan I am aware of – including those developed by President Bush, Congressman Shaw, and Senator Hagel – has what are called “government-organized” accounts. A so-called “central administrative authority” would, according to the White House fact sheet on the President’s proposal, “collect personal retirement account contributions, manage investments, maintain records, and facilitate withdrawals at retirement.” This administrative structure limits choices and services, but takes advantage of economies of scale to provide lower costs (although still about ten times higher than the cost of administering the current Social Security system).

Establishing a bank option would entail setting up what are called “privately-organized” accounts, like existing IRAs or the accounts in the U.K. and Chilean individual accounts system.

[1] The views expressed in this testimony are mine alone.

In addition to loss of economies of scale and the higher administrative costs to track each individual account, a system would need to be set up to monitor early withdrawals and other program rules. The costs of such accounts, according to the Congressional Budget Office, the observation of 401(k) plans, and the experience of Chile and the United Kingdom, could eat up more than 30 or 40 percent of the final account balance.

***Second, Galveston does not provide a model that is relevant for nationwide Social Security reform*.**

The Galveston Plan bears little resemblance to individual accounts plans. Instead, county invests pension funds in the market; individual workers do not have accounts or any control over investment decisions. Participation in the Galveston plan is mandatory. The Galveston Plan also features higher payroll tax contributions: 13.9 percent of payroll, as compared to 12.4 percent under the traditional Social Security system.

In addition, retirement benefits are generally lower in the Galveston plan than under Social Security. The plan has no spousal benefits and no adjustments for the cost of living. According to a study by the Social Security Administration, the Galveston Plan "offers a lower initial ongoing benefit than Social Security for single workers with low earnings and for married workers at the low, middle, and high earnings level… after 15 years Galveston's benefits are lower than Social Security's for all family/earner types with the exception of single, very high earners. After 20 years, all of Galveston's benefits are lower relative to Social Security's."

Finally, and most importantly, Galveston could not provide a model for the country as a whole. The several thousand municipal employees in the Galveston plan do not make any contributions to support current Social Security beneficiaries. If the United States as a whole adopted a Galveston-like plan, *there would be no one left to pay the $500 billion annual cost of benefits for the nation's 45 million current Social Security beneficiaries*.

In other words, Galveston's municipal employees are "free riders" who are escaping their share of the national obligation to finance Social Security for current retirees. The United States as a whole cannot "free ride" in the way that government employees one relatively small county can.

***Third, and most fundamentally, there is no such thing as a guaranteed higher rate of return*.**

The basic principal of financial markets is that you only get higher returns as compensation for taking greater risks. As Nobel Prize winner (and supporter of individual accounts) Gary Becker explained, "There are no freebies from such investments since the higher return on stocks is related to their greater risk and other trade-offs between stocks and different assets."

Social Security benefits are not subject to any market risk. In fact, Social Security provides critical insurance against becoming disabled, dying, or outliving ones savings. No

financial instruments provide this range of benefits and, if they did, they would be extremely expensive.

Comparison of the rate of return in Social Security to the rate of return in private markets are misleading because they ignore the insurance provided by Social Security and the greater risks associated with equity investments. More fundamentally, these comparisons ignore the cost of paying for *current* Social Security beneficiaries – a cost that must be paid regardless of whether *future* retirees get benefits from Social Security or from market-based investments.

As Greg Mankiw, former Chairman of President Bush's Council of Economic Advisers explained,

> "Admittedly, some of Bush's arguments are off the mark. When he compares the 2% real return a worker now gets from Social Security with the 6% real return offered by a portfolio of stocks and bonds, he neglects to mention that the Social Security fund still owes a huge amount to those now or soon to be retired. This liability – the overhang from giving earlier generations more than they put into the system – doesn't disappear with privatization. Whatever system Bush comes up with, it won't give young workers a 6% return."

Every policy analyst and economist, whether they support or oppose accounts, would agree with my statements about the bank option, Galveston and rates of return. I would, however, like to make one more point:

Fourth, in my judgment the risks associated with a proposal like the President's are unjustifiable.

The President's proposal would not increase the return to Social Security, in fact for many beneficiaries it would lower it. Under the President's accounts proposal, you need to get a rate of return of 3 percent above inflation just to break even – that is about 5.8 percent total annual return. By way of comparison, CDs currently have a 3.5 percent rate of return. That is a surefire way to lose money under the President's proposal.

Even a sounder investment strategy would still be highly problematic. A study by noted financial economist Robert Shiller, the author of *Irrational Exuberance* and a professor at Yale University, found that people that held accounts modeled on the President's "lifecycle" proposal would lose money between 32 and 71 percent of the time. This is not a risk I would recommend taking with a secure retirement benefit.

***In conclusion*,**

Investing and risk taking have an important place to play in wealth accumulation and retirement security. Policymakers should do more to encourage savings by moderate-income families through IRAs and 401(k)s. But I do not recommend reducing Social Security benefits

and replacing them with an individual account that is subject to market risk. And if Congress does choose to establish individual accounts, I would strongly recommend not including a bank option.

Thank you, I look forward to the Committee's questions.