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SOCIAL SECURITY'S PROTECTIONS FOR AFRICAN AMERICANS

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CENTER ON BUDGET
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Chairman Shaw and members of the subcommittee, thank you for inviting me to testify today. I am Kilolo Kijakazi, a senior policy analyst at the Center on Budget and Policy Priorities. My testimony will focus on the importance of Social Security to African Americans, the limitations of some proposals to reform Social Security using individual accounts and an alternative approach that would maintain the guaranteed benefit provided by Social Security.

Social Security's Success

Social Security has been one of the country's most successful social programs. It 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 over 11 million seniors out of poverty in 1997, reducing the elderly poverty rate from about 49 percent to about 12 percent. Additionally, Social Security has become more effective in reducing poverty over time. In 1970, Social Security reduced the poverty rate among the elderly from about 50 percent to 17 percent, compared to 12 percent today.

Social Security payments provide the majority of the income of poor and near poor elders. In 1997, it was the major source of income for 66 percent of beneficiaries age 65 or older and it contributed 90 percent or more of income for about 33 percent of these individuals.

The Importance of Social Security to African Americans

Social Security is particularly important to African Americans. Elderly African Americans rely on Social Security benefits more than white elders rely on the program. In 1997, Social Security benefits made up 43 percent of the income received by elderly African Americans and their spouses, compared to 36 percent of the income of elderly whites. This is not surprising given the lower rates of pension coverage for African Americans. Pension income was received by only one third of elderly African Americans and their spouses. By comparison, 44 percent of elderly whites and their spouses receive pension income. Moreover, African Americans are disproportionately represented among low-wage workers. It is, therefore, more difficult to set aside savings for retirement to supplement Social Security. While Social Security is intended to be one leg of a "three-legged stool" for retirement income, the lack of pension coverage and limited resources for savings place greater weight on Social Security as a reliable source of income for many African Americans.

Protections of Social Security

The argument has been made that Social Security provides a lower rate of return to African Americans because this community has a lower life expectancy than the general population. Based on this premise, an African-American worker would contribute payroll taxes, but would not live long enough to receive Social Security benefits sufficient to achieve the same rate of return as non-African-American beneficiaries. This reasoning is faulty, however, as it overlooks important protections Social

Security provides for African-American and low-wage workers including disability and survivors insurance.

The design of the Social Security system helps to compensate African Americans for their shorter life expectancy. There are three aspects of the program that provide such protection. First, Social Security's benefit formula is progressive. Benefits replace a larger percentage of pre-retirement earnings for low-wage workers than high-wage workers. Since African Americans are disproportionately represented among low-wage earners, they gain from this formula.

The second feature is the option for early retirement. The Social Security system allows workers either to retire with full benefits at a given age, currently 65, or to retire early with reduced benefits. A worker can take early retirement at age 62. Workers who retire at 62 contribute payroll taxes for three fewer years. They also begin receiving benefits three years earlier, with monthly benefits reduced to compensate for the increased number of years during which they will receive benefits.

The reduction in the monthly benefit amount for those who retire early is based on actuarial tables and is intended to make the amount of benefits received from age 62 to the point of death equivalent, on average, to the amount of benefits retirees would receive if they waited until the "normal retirement age" to retire. Over the population as a whole, the Social Security early retirement option is close to a wash — the lower monthly benefits paid are designed to offset the increased number of years for which benefits will be received.

The story is different, however, for African Americans. Given the shorter life span for African Americans, the benefits these early retirees receive from age 62 to the end of their lives exceed the benefits they would receive, as a group, if they waited until 65 to retire. Starting to receive benefits several years earlier *increases* the total benefits they receive and raises their average rate of return.

Two-thirds of all workers, including African Americans retire early. Thus, most African-American retirees are compensated for their shorter life span by this aspect of Social Security.

The third component of Social Security that mitigates the impact of higher mortality among African Americans is the comprehensive nature of the program. Social Security is not solely a retirement program, but also an insurance system that protects against risks that are unforseen or for which workers are not sufficiently prepared. In addition to benefits for retired workers, Social Security provides benefits to the worker's spouse and dependents when the worker retires or becomes disabled, as well as survivors benefits if the worker dies. The divorced spouse of the retired or deceased worker also is generally entitled to benefits.

African Americans benefit disproportionately from the disability and survivors components of Social Security. While African Americans account for 11 percent of the civilian labor force, they comprise 18 percent of the workers receiving Social Security disability benefits in 1996. When a worker becomes disabled, the worker's dependents also become eligible for Social Security benefits. African Americans made up 23 percent of children and 15 percent of the spouses who received Social Security benefits in 1996 because workers in their families were disabled.

As a result of the above-average mortality rates among African Americans, the African-American community benefits disproportionately from the feature of Social Security that provides benefits to non-elderly survivors. Although African-American children comprise about 16 percent of all children in the United States, they made up 24 percent of the children receiving survivors benefits in 1996. African Americans also accounted for 21 percent of the spouses with children who received survivors benefits. Benefits for non-aged survivors are one of the aspects of Social Security most favorable to African-American workers.

Some studies have attempted to estimate Social Security's rate of return for African Americans. The Social Security Administration's (SSA) Office of the Chief Actuary has assessed some of these estimates, such as those used by Heritage, as well as the methodology for reaching the estimates. The actuaries found that the methodology was inaccurate; consequently the estimates were wrong. Furthermore, Robert Myers, a former Chief Actuary of SSA, heavily criticized such attempts to calculate rates of return, particularly those by Heritage, without sufficient information.

Most of these studies faced a major limitation. They did not have access to databases on actual earnings records of workers and benefits of retirees, the Continuous Work History database. This information is confidential and is not released to the public so that the privacy of workers and beneficiaries will be protected. These data have only been available to Treasury and SSA. One study that did not face this limitation was conducted by employees of the Treasury Department (Duggan, Gillingham, and Greenlees). These researchers did have access to the Continuous Work History database. Their research showed that African Americans had a slightly higher rate of return from Social Security retirees and survivors than the general population. A second study by the Social Security Administration also used this database and looked specifically at disability insurance. It shows that African Americans received substantially more benefits from Social Security Disability Insurance in relation to the taxes they have paid than whites do. Thus, despite the shorter life span of African Americans, aspects of the program such as the progressive benefit, early retirement and comprehensive insurance offset the effects of higher mortality rates for this community.

The Need for Reform

Although the Social Security system has clearly served as an important source of income for the general population, including African Americans, demographic changes necessitate reforms in the program to maintain solvency. The baby-boom generation is aging and will begin retiring in large numbers after 2010. By 2025, most of this group will be 65 or older.

Moreover, rising life expectancy will further increase the number and proportion of the population that is elderly. The Social Security actuaries' projections, reported by the Social Security trustees, show the number of people age 65 and older will nearly double from 34 million in 1995 to 61 million in 2025. During that period, the proportion of the total population that is elderly will grow from 12.5 percent to 18.2 percent. There also will be a decline in the rate of growth of the working-age population. As a result of these various changes, the ratio of workers to Social Security beneficiaries will decrease from just over three-to-one today to two-to-one in 2030, and remain at approximately this level through 2075, the last year of the actuaries' projections. At that point, the elderly will comprise 22.7 percent of the total population.

Social Security payroll tax revenues currently exceed benefit payments and the trust funds are accumulating assets. The demographic changes that lie ahead, however, will result in substantial increases in benefit payments in coming decades and create an actuarial imbalance in the program over the long term. The actuaries project that the assets in the trust funds will be exhausted by 2032.

After 2032, the trust funds will be dependent entirely on payroll tax collections for income. From that time on, Social Security will be insolvent because it will not have sufficient annual income to make the full benefit payments to which its beneficiaries are entitled by law. This does *not* mean Social Security will collapse at that time and have no funds to pay any benefits; to the contrary, the problem is that after 2032, incoming payroll taxes are projected to be sufficient to cover about *75 percent* of the benefit payments, rather than 100 percent of these costs. Policymakers need to make policy changes that eliminate this shortfall.

Drawbacks of Some Individual Account Proposals

Some proposals to reform Social Security would be particularly disadvantageous to African Americans. Proposals to fully or partially privatize Social Security by diverting payroll taxes from the Social Security trust funds to individual accounts would have a detrimental impact on low-wage workers and African Americans.

How is it possible for advocates of individual accounts that replace Social Security benefits to claim that their proposals will benefit African Americans and low-wage workers? The answer is proponents of these accounts often fail to factor in the costs and risk of such individual accounts when determining the rate of return for the accounts. There are three such types of costs — transition costs, the administrative costs, and the cost to convert accounts to annuities.

If retirement benefits are privatized, the payroll taxes that are currently used to finance Social Security retirement benefits will instead be deposited in individual accounts. That will create a financing gap — funds will be needed to fulfill the government's obligation to pay Social Security benefits to current retirees and those nearing retirement. Robert Reischauer, a senior fellow at the Brookings Institution, addressed this point in his statement at the White House Forum on Social Security in New

Mexico, July 27, 1998. “Whether we retain the existing system or privatize it, this unfunded liability will have to be met unless we renege on the benefits promised to today’s elderly and near elderly. Dealing with the unfunded liability inescapably will reduce the returns workers can expect on their contributions.”

Under a privatized system that diverts all payroll taxes into individual accounts, workers would have to pay a new tax to continue financing the Social Security benefits of current and soon-to-be retirees. As senior researcher Paul Yakoboski of the Employee Benefit Research Institute recently testified, “Because the current Social Security system is largely pay-as-you-go, most of what workers pay into the system funds today’s benefits. . . . [O]n top of paying current benefits, workers moving to a privatized system would have to pay ‘twice’ — for the benefits going to today’s beneficiaries and again to their own [personal] accounts.” For this reason, the General Accounting Office has noted that if Social Security retirement benefits were privatized, “the [payroll] contributions needed to fund both current and future retirement liabilities would clearly be higher than those currently collected.”

A study conducted by the Employee Benefit Research Institute incorporated transition costs into its calculations. It found that for workers who are 21 today and receive low wages, the rate of return would be *lower* under the individual accounts options it examined than under all options it examined to restore long-term balance to Social Security without individual accounts.

Administrative costs further reduce the rate of return for individual accounts. Accounts that are designed like IRA accounts will result in significant administrative costs and management fees, which would be paid out of the proceeds of the accounts and consequently reduce the amounts available in those accounts to pay retirement benefits. Moreover, additional costs are incurred when the funds in these accounts are converted to lifetime annuities upon retirement.

Based on data on IRA accounts, two eminent Social Security experts — Henry Aaron of the Brookings Institution and Peter Diamond of M.I.T. — have estimated that the administrative costs for retirement accounts like IRAs would consume 20 percent of the amounts that otherwise would be available in these accounts to pay retirement benefits. They note that a one percent annual charge on funds in such accounts eats up, over a 40-year work career, 20 percent of the funds in the accounts. The 1994-1996 Advisory Council on Social Security estimated an annual charge of one percent on the assets in privately managed individual accounts.

Furthermore, recent financial data indicate that a one percent annual charge is a conservative estimate. In 1997, the average annual charge on stock mutual funds was 1.2 percent of the amounts invested in those funds.   In addition, Diamond has noted that administrative and management costs consume approximately 20 percent of the amounts in individual accounts in Chile’s privatized retirement system and more than 20 percent of the funds in privatized retirement accounts in Great Britain and Argentina.

Some of these costs are fixed-dollar expenses that do not vary with the size of an account. As a result, such costs would generally consume a larger percentage of the amounts in smaller-than-average accounts (and a smaller percentage of the amounts in large accounts). This suggests these costs would, on average, consume more than 20 percent of the funds in the accounts of lower-wage workers. That is of particular significance to African Americans since, as a group, they receive lower-than-average wages and would consequently have smaller-than-average accounts.

To these costs must be added the costs of converting an individual account to an annuity upon retirement. The leading research on this matter indicates that an additional 15 percent to 20 percent of the value of an individual account is consumed by the costs that private firms charge for converting accounts to annuities. The General Accounting Office recently noted that "While individual annuities are available, they can be costly especially relative to annuities provided through Social Security."

Taking all of these costs into account — both administrative and management fees and the costs of converting accounts to annuities — Aaron estimates that at least 30 percent and as much as 50 percent of the amounts amassed in individual accounts similar to IRAs would be consumed by these costs rather than being available to provide retirement income. (While the administrative cost would be lower for centrally managed accounts similar to the federal employees Thrift Savings Plan, the cost would still be significantly higher than the administrative cost for Social Security.)

In addition to the costs of these individual accounts, there are some risks. Retirees who are particularly lucky or wise in their investments could receive retirement income from individual accounts that more than offsets their loss of Social Security benefits. But retirees who are less lucky or wise, including those who retire and convert their account to a lifetime annuity in a year the stock market is down, would likely face large reductions in the income they have to live on in their declining years.

A recent GAO report takes note of these issues. "There is a much greater risk for significant deterioration of an individual's 'nest egg' under a system of individual accounts," the GAO wrote. "Not only would individuals bear the risk that market returns would fall overall but also that their own investments would perform poorly even if the market, as a whole, did well.

This is a concern for workers in general — surveys have found Americans are not very knowledgeable about financial markets — and a particular concern for lower-wage workers, who generally would not be able to afford as good investment advice as individuals at higher income levels. Moreover, lower-income groups have less investment experience and would be more likely to invest in an overly conservative manner because they could not afford to expose the funds in their accounts to much risk. African Americans make up disproportionate shares of the low-income population. As a result, they would be likely to receive a somewhat lower-than-average return on amounts invested even while, as explained above, they would likely pay an above-average percentage of their holdings in fees.

An Alternative Approach

There is an alternative to plans that would fund individual accounts by diverting payroll taxes from the Social Security trust funds. In his 1999 State of the Union address, President Clinton proposed to commit 12 percent of the unified budget surplus to the creation of USA accounts.

A key difference between the previously discussed accounts and the President's proposals is that the first step taken would be to reestablish solvency within the defined benefit portion of the Social Security system, without redirecting any of the payroll revenue to USA accounts. The President's plan would preserve the guaranteed benefit that is the cornerstone of the Social Security system and would not divert any revenue from the trust funds.

Furthermore, the USA accounts are designed to be progressive in two ways. First the government would contribute the same amount of money to each worker's account. This means the contribution will represent a higher percentage of income for low-wage earners than for high-wage earners. Second, under this proposal, the government would also provide progressive matching contributions to workers who add their own savings to their accounts. For example, a low-wage worker might receive a dollar match for each dollar he or she contributes to the account while an average-wage worker might receive a match of 50 cents for each dollar he or she contributes.

This proposal would leave intact the basic Social Security system that has played such a vital role in the economic well-being of African Americans. At the same time, it would encourage savings using a design that targets resources to workers who would benefit the most from a boost in their retirement income.