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**Testimony before  
the President's Commission  
to Strengthen Social Security**

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I appreciate the opportunity to appear before you today to discuss some aspects of Social Security reform. This is an extremely important subject, and I would like to thank the Co-Chairman for scheduling this hearing. Let me begin by noting that while I am the Senior Policy Analyst for Social Security at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation.

This afternoon, I would like to make five points. Three of them are about how to structure a Personal Retirement Account (PRA) that is part of Social Security. One is about how to regulate those accounts, and the last deals with the question of raising or eliminating the existing cap on wages.

## **Social Security Part B**

PRAs can and should become an integral part of the Social Security system. If the Commission decides to incorporate PRAs in their final recommendations, the fact that PRAs supplement the existing version of the program should be made clear. One way to accomplish this would be to re-name the existing program "*Social Security Part A.*" The portion of Social Security which incorporates PRAs would be named "*Social Security Part B.*" Both parts would be funded by the same payroll taxes that a worker pays today, not by new taxes. Most of the payroll taxes would go into Part A, and the rest would go to Part B to fund a PRA. Whereas today's benefits are completely paid through Part A, future retirees' retirement benefits would be paid through a combination of Part A and Part B.

## **Progressive Contributions to Personal Retirement Accounts**

In order to ensure that a reformed Social Security with PRAs continues to offer a progressive benefit, which gives lower income workers higher benefits the commission should consider creating a progressive carve-out. Under this system, versions of which appear in both the Kolbe-Stenholm and the DeMint reform plans, workers' contributions to their PRAs would be graduated in much the same way that income tax rates are already.

For example, workers could contribute an amount of existing payroll taxes equal to 7 percent of their first \$10,000 in come, 6 percent of their income between \$10,000 and \$20,000, graduated down to contributions of 2 percent of the amount between \$70,000 and the taxable maximum. In all cases, I am assuming that PRA contributions would be carved-out of current OASI taxes.

A progressive contribution rate would allow lower income workers to amass assets at a faster rate than those with higher incomes. The progressive contribution rate would reduce the chance that lower income workers would be subject to higher administrative costs. In the event of an early death, it would also allow these workers to leave proportionally higher assets to their families. Allowing low income workers the opportunity to build assets would be a major step towards breaking the cycle of poverty and reducing the income gap between rich and poor.

## **Allow Married Couples to Split their PRA Contributions**

The Commission's interim report highlighted some of the ways that the current Social Security system disadvantages women. This is especially true for those who remain home to care for children or whose marriages fail to last the necessary ten years to qualify for survivors and spousal benefits. One way to reduce these problems would be to require that married couples split their PRA contributions

with their spouse. I believe that this is far superior to allowing a PRA to be split as part of a divorce settlement.

As an example of how this could work, if there is a 2% across the board carve-out, and a couple has a male \$60,000 earner and a female \$40,000 earner, the \$60,000 earner with a \$1,200 total PRA contribution would send \$600 to his account and \$600 to hers. She would send \$400 to hers and \$400 to his for a total PRA contribution of \$1,000 each.

Income splitting assures a woman that her account continues to receive contributions even if she is out of the labor force for a period of time. This feature would also help to even out lifetime income among the genders. Finally, it avoids the uncertainty of a judge's property decisions in the event of a divorce. Experience in Australia has shown that in divorces, the wife tends to get the family house, while the husband retains his full retirement account. While this advantages the wife in the short run, it also forces her to finance all or much of her retirement by selling it.

### **The Securities and Exchange Commission, Not SSA Should Regulate PRAs**

PRAs should be carefully regulated and closely monitored. However, that job should be entrusted to an existing financial regulator such as the Securities and Exchange Commission. Under no circumstances, should it go to the Social Security Administration (SSA).

While SSA does an admirable job of calculating and delivering benefits to millions of Americans, it has no experience whatever in investing. The Department of the Treasury collects taxes for SSA, and the Bureau of the Public Debt turns any taxes that are not immediately spent into special issue Treasury bonds. But at no point does the SSA have substantive dealings with financial markets or private-sector financial institutions.

In fact, allowing the SSA to regulate personal retirement accounts could create a serious conflict of interest. If Congress created a voluntary system of PRAs, where workers can choose whether they wish to divert a portion of their Social Security taxes into such an account or remain in the existing SSA-administered version, that would place the two systems in competition with each other. If SSA had the ability to regulate personal retirement accounts, it could be tempted to use its authority to obstruct the development of these accounts with unnecessarily heavy regulatory burdens.

As a result, SSA should have no role in regulating financial institutions that manage personal retirement accounts. A massive bureaucracy that can take years to determine eligibility for disability claims simply does not have the expertise or ability to understand the innovative and rapidly changing financial world. SSA could add nothing positive either to funds management or to consumer protection, and it could do a great deal of damage by misunderstanding the nature of the business.

### **What About Eliminating the Income Cap?**

While it is clear from the Commission's interim report that Social Security needs major reforms if my 15 year-old daughter Meredith is to receive all of her benefits, Heritage Foundation research shows that raising the income cap will only delay a solution. Back in 1999, my colleagues Gareth Davis and Mark Wilson examined the consequences of assessing Social Security taxes on all earned income.

They found that eliminating the cap on taxable wages would:

- **Result in the largest tax increase in the history of the United States**--\$425.2 billion in nominal dollars over five years.
- **Fail to save Social Security from bankruptcy**; it would push back the system's insolvency date by only six years.
- **Increase the top federal marginal effective tax rate** on labor income to 54.9 percent, its highest level since the 1970s.
- **Reduce the family budgets of 23.4 million Americans** by an average of \$9,147 in the first year alone after the tax cap is removed.
- **Weaken the economy** by reducing the number of job opportunities by 219,000 in 2004 and the amount of personal savings by \$34.4 billion that year as well.

I have attached a copy of their report to my testimony. We are in the process of updating it, and will supply the Commission with the revised report as soon as it is ready. A key finding is just who would end up paying the increased taxes. Contrary to what proponents of this tax increase suggest, it would not affect only the Donald Trumps and Michael Jordans of the world.

Of the 9.2 million workers we identified in 1999 who would be directly affected:

- **7.6 million (83 percent) are men.** Over two-thirds, or 6.2 million, of these men are aged 35 to 54; another 1.5 million are over the age of 54 and nearing or eligible for retirement.
- **7.3 million (79.6 percent) are married.**
- **4.3 million (46.5 percent) are married with children.**
- **6.8 million (74.3 percent) have college degrees**; 1.2 million (13.3 percent) are high school graduates or less.
- **Nearly half (4.5 million workers) live in seven states:** California (1.4 million), Florida (414,000), Illinois (498,000), New Jersey (431,000), New York (729,000), Pennsylvania (386,000), and Texas (615,000). Most (5.3 million, or 57.9 percent) live in the suburbs. Another 2.1 million (22.9 percent) live in central cities.
- **Over two-thirds (6.5 million) are private-sector wage and salary workers**; 2.1 million (22.4 percent) are self-employed.
- **Nearly one in ten (797,000) is a union member.**
- **Two-thirds (6.1 million) work in six major industries:** manufacturing (1.9 million); finance, insurance, and real estate (1.1 million); other professional services (1.1 million); business and repair services (719,000); medical services (681,000); and retail trade (618,000).
- **While over two-thirds (6.2 million) are in executive, managerial, and professional specialty occupations**, not all of the workers affected are doctors, lawyers, or chief executive officers. **One million of the 9.2 million affected workers are teachers, nurses, truck drivers, computer analysts, farmers, police officers, mechanics, and repairers.**

Again, the truly sad part is that after such a massive tax increase, Social Security will still face the same problems as before. The only effect would be to delay those problems for about six years. While the program would gain additional income initially, eventually, it would have to pay benefits on those higher incomes. This quite rapidly eliminates the short-term revenue gains to the system.

While currently, SSA considers San Diego Padres star Tony Gwynn as only earning \$80,400 for purposes of his benefit calculations, if the tax cap is raised, he would receive benefits based upon his whole salary. It is possible to tax on Mr. Gwynn's entire income and to only pay him benefits on a lower amount of his income. However, this would be a significant departure from the traditional linkage between the taxes a worker pays and his or her benefits. Such a move would re-cast Social Security towards a welfare program and probably erode the public support of the program. Raising the taxable wage base accomplishes little at great risk.

## Conclusion

Again, thank you for the opportunity to testify before you. The Commission faces a significant challenge in resolving Social Security's coming financial problems while preserving its essential nature. Of the potential solutions, only creating a Social Security Part B made up of a PRA funded with a portion of existing taxes has the potential to succeed without reducing an individual's rate of return.

Hopefully, the Commission proposal will resolve Social Security's problems in a responsible, cost-effective manner. This is not a theoretical situation. When my 15 year old daughter retires in about 50 years, the Social Security trust fund will be a distant memory. We owe it to our children to leave them a solution and not an excuse.

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