Testimony of

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Before the
President's Commission
to Strengthen Social Security

October 18, 2001

Strengthening Social Insurance

My name is Vincent R. Sombrotto. I am President of the National Association of Letter Carriers. The NALC is a trade union that represents 242,000 letter carriers employed by the United States Postal Service as well as the interests of 95,000 retired postal employees. In addition, I have served as the Chairman of the Employee Thrift Advisory Council (ETAC) since 1987. The Council was established with the creation of the Federal Employees' Retirement System (FERS) to advise an independent agency of the federal government, the Federal Retirement Thrift Investment Board, on the management of the Thrift Savings Plan (TSP). The TSP is often described as the 401(k) for government workers, but it is actually part of a three-tiered retirement plan that also includes a defined benefit pension and Social Security. Some 2.5 million federal employees have TSP accounts and have saved nearly $100 billion through them.

As chairman of ETAC, I am a strong supporter of the Thrift Savings Plan and a committed advocate of encouraging ordinary working Americans to invest in stocks and bonds to build their future retirement income. But as President of NALC and as a concerned citizen who remembers personally the devastating poverty of the old, the orphaned and the disabled that Social Security has helped to end, I support strengthening Social Security as a system of social insurance, not transforming it into just another mutual fund. For these reasons, I wish to thank you for the opportunity to testify today.

Before addressing the issues of individual accounts and ways to strengthen Social Security, I must first say three things about the nature of Social Security.

The nature of Social Security

First, as many others have noted, Social Security is not a pension plan and has never been one. It is a social insurance plan that starts from the premise that "we are all in this together. " It not only insures against poverty in old age as a result of a lifetime of low-income employment – a very common and undeniable feature of our market economy -- but it also protects our families from destitution resulting from a worker's early death or disability. The country's ability to finance this safety net of social insurance is not determined by the balance of a trust fund over an arbitrary period of 75-years or by the ratio of workers to retirees at a particular point in time. Rather it is based on our national income and the political will to allocate sufficient resources to it. Even under the most pessimistic projections of Social Security's Trustees, our nation will be rich enough to afford Social Security as long as the political will exists.

Second, as perhaps many are afraid to say, Social Security is one of our country's chief weapons against the sort of gross inequality that can destroy a democracy over time. As we have abandoned one egalitarian policy tool after another in recent years – the estate tax being only the latest example – we can ill-afford to undermine the mild progressivity of Social Security, which allows for a modest redistribution of income from the well-off to the working poor.

Third, contrary to the implication of some commentary on the issue, the government bonds in the Social Security Trust Fund are <u>real</u> assets – as Federal Reserve Chairman Alan Greenspan confirmed in testimony before the Senate last month. These bonds are making it possible to pay off the public debt of the nation today, which is made up of Treasury securities sold to people to build the interstate highway system, win the Cold War and to finance other public achievements of our country. By helping pay off the public debt today, the Trust Fund's bonds are improving our ability to finance Social Security benefits in the future. Of course, all bonds, whether issued by companies or the government, are IOUs. But the trust fund bonds that are benefiting Americans today, are backed by the "full faith and credit" of the United States and there should be no doubt that they will be honored in the future.

Thus, any conclusions this commission might reach based on calculations of "investment returns" on payroll taxes that exclude disability and survivor benefits or the social benefit of reduced inequality should be viewed with great skepticism. And any proposal advanced by stoking fears about the real value of the bonds held by the Social Security Trust Fund should be dismissed out of hand. Putting it more positively, this commission will succeed if it develops proposals to preserve and strengthen the universal social insurance nature of Social Security.

Individual investment accounts

As any of my colleagues from the 13 other unions and management associations who are also members of the Employee Thrift Advisory Committee will tell you, I am an avid champion of ordinary workers investing in stocks and bonds for retirement. Over the years, I have worked hard to convince every letter carrier in America to contribute to the federal Thrift Savings Plan. And I am proud to report that the vast majority of them do so.

Nevertheless, NALC would oppose any proposal to create individual investment accounts that divert existing Federal Insurance Contributions Act (FICA) taxes into such accounts. We would do so for

three reasons. First, it would necessarily reduce guaranteed benefits and subject the basic safety net to unacceptable risks. Second, it would reinforce and extend into retirement the inequality of today's labor market instead of mitigating it. And third, the proposal risks turning the long-term financing problem now facing Social Security into a near-term funding crisis. I wish to briefly elaborate each of these points.

Let me speak about risk first. Given my strong support for the Thrift Savings Plan, it may seem odd that I oppose individual investment accounts for Social Security as too risky. Indeed, the Thrift Savings Plan is often cited as a model for individual investment accounts within Social Security.

However, it is important to note that the TSP is designed to supplement guaranteed benefits provided by Social Security and a Basic Annuity program. It is one part of the FERS program, a well-designed system that balances risks and returns and offsets these risks with basic guarantees. Specifically, FERS balances the credit and market risk of investing in the TSP with the security of annuity and Old Age Survivors and Disability Insurance (OASDI) benefits that are guaranteed by law. It would not be wise to further expose federal employees to even more risk by diverting Social Security payroll taxes into individual investment accounts. This is particularly true if such a diversion forces cuts in guaranteed Social Security benefits.

And federal workers are not alone in their heightened exposure to credit and market risk. There has been a revolution in private pension coverage in recent decades as companies have replaced defined benefit plans that guarantee retirement benefits with defined contribution plans under which benefits depend on how well workers invest their 401(k) funds and, frankly, how lucky they are. Given that American workers have already taken on a tremendous amount of "401(k)" risk in recent years, subjecting them to even greater financial risk by investing their Social Security contributions in stocks and bonds appears to be a reckless course. Worker-investors have been reminded of this risk in recent months: The 1990s bull market has come to a definitive end and the value of S&P 500 stocks has declined significantly since the spring of 2000. TSP participants have seen the value of their C Fund investments fall by 23% this year alone. If a portion of their Social Security funds had also been invested in stocks, their losses would have been even greater. Granted, few people have lost money by investing in the stock market over the long run, but their level of returns can vary quite dramatically depending on the month and year people begin and end their investments.

A second major problem with individual accounts is that they would undercut the progressive nature of Social Security. As guaranteed benefits would have to be cut in the wake of any diversion of payroll taxes into private accounts, the ability to give lower income workers greater benefits would be reduced. Such workers, whose tolerance for risk is necessarily lower than middle-income and high-income workers, would either have to adopt safe, but low-return investment strategies or risk losing benefits that are now guaranteed. Upper income participants, who could absorb any losses in their individual Social Security accounts, could afford to invest more aggressively. The end result is that higher-income workers would likely enjoy greater benefits from their accounts than low-income workers would. The gross inequality of the modern labor market would be reinforced and extended into retirement.

Finally, as many other observers have noted, the creation of individual accounts through diversion of payroll taxes into individual accounts would only worsen the problem it claims to address. If the disease to be treated is the eventual depletion of the Trust Fund, the medicine of private accounts is worse than the disease. Instead of depleting the Trust Fund in 2038, individual accounts would accelerate the depletion by decades. If this Commission recommends such a course, it must be prepared to honestly confront this financing problem, which is too often dismissed as a so-called transition cost. You have three choices: raising taxes, using any long-term budget surplus, or cutting benefits. The feasibility of raising taxes in the current political climate seems highly unlikely and give recent events, it remains to be seen what kind of budget surplus, if any, there will be. Therefore, it is incumbent upon those advocating diversion of payroll taxes into individual accounts to spell out the cuts in Social Security benefits you propose to pay for the transition to individual accounts. If you don't, you risk turning a long-term funding shortfall into a near-term financial crisis. Under current law, we have enough time to take more modest steps to ensure the long-term strength of the Social Security system. We should use the time to act wisely.

NALC could support individual accounts administered by the Social Security Administration if they were designed to supplement the existing program and if the practical difficulties of administering such accounts could be overcome. Millions of Americans have no pension coverage beyond Social Security and many are saving little if anything for retirement. A so-called "Social Security-Plus" program could be structured along the lines of the TSP, with the Social Security Administration handling the administration of individual accounts invested in a limited number of index funds. The additional funds

would belong to individual contributors and could be invested by private sector managers under contract with the SSA. Mandating some level of matching contributions by employers that do not otherwise offer their employees pension coverage could also be considered under such a system.

A Social Security-Plus program would actually boost national savings, which has actually turned negative in recent years. More importantly, it would not endanger the basic social safety net provided by the existing Social Security program. However, it is not clear that it could overcome the single biggest problem facing low-income investors: the high administrative fees charged by mutual funds and brokers for individual accounts. Frank Cavanaugh, the former Executive Director of the Federal Retirement Thrift Investment Board, has investigated this problem and has found that private companies charge $300-$500 annually to administer small individual accounts. That would eat up most, if not all, the contributions of typical workers saving one or two percent of their pay.

The low cost of administering the TSP accounts (which is less than 6 basis points or 0.06 percent) stems from the federal government's unique capabilities – which include computerized payrolls, sophisticated communication systems and professional human resource managers. While an even larger TSP-style program run by the SSA might be affordable, the administrative costs of handling contributions from 150 million workers employed by some 6.5 million businesses with few of the government's capabilities should not be underestimated.

Of course, while a Social Security-Plus program would address the too-little discussed "pension" crisis in America, it would not address the problems facing the core Social Security program, a topic to which I now turn.

Strengthening Social Security

Some 160,000 NALC members contribute to Social Security as FERS-covered employees and most of the rest qualify for Social Security by virtue of private sector employment. NALC has therefore taken a great interest in Social Security in recent years. Indeed, we have been working to correct inequities in the program caused by two 1980s-era laws that were designed reduce the federal budget deficit. These laws, known as the Government Pension Offset and the Windfall Elimination Provision, reduce the Social Security benefits of federal and postal employees who collect benefits from the Civil Service Retirement System, the plan that covers federal and postal employees hired before 1984. We are confident that

Congress will correct these inequities even before this Commission completes its work. So our comments will be limited to the primary focus of this Commission: How to ensure the long-term health of the Social Security program.

The latest report of the Social Security Trust Fund trustees indicates that projected Social Security benefits will exceed projected payroll taxes by 1.86 percent of covered payroll over the next 75 years as a result of the coming retirement of the Baby Boom generation. This projection reflects fairly pessimistic assumptions about future economic growth that may or may not hold true. It also reflects certain demographic factors that are largely undeniable, some positive and some negative. The chief positive factor is the increasing life expectancy of American citizens. The chief negative factor is decline in the ratio of workers to Social Security recipients. NALC understands that there is no such thing as a free lunch and that Congress must take some action to keep Social Security strong.

However, the same report makes it clear that relatively modest changes could restore actuarial balance to the system: A permanent reduction of benefits of 13 percent or a permanent increase in revenues of 15 percent or some combination of benefit cuts and tax increases is required. Our view is that the current level of Social Security benefits is not extravagant and should not be reduced. Thus efforts to strengthen Social Security should focus on bolstering the system's revenues.

The Commission should reject the notion that taxes can never be raised to overcome the projected shortfall in the Social Security Trust Fund. If Americans are living longer why shouldn't we pay slightly higher payroll taxes to handle it? An increase of the OASDI payroll tax of less than one percent each on workers and employers could fully offset the shortfall. Nobody wants to pay higher taxes, certainly not the members of my union, but such an increase could be phased in and is certainly affordable. Even under the conservative (i.e., pessimistic) economic assumptions used in the Trustees report, the average per-capital real income of Americans will be at least 30 percent higher in 2038 than it is today. If productivity and the economy grow faster, as is very likely, real incomes could be 50-60 percent greater. So if we had to, we could certainly afford to modestly raise payroll tax rates.

Of course, the size of any increase in payroll taxes could and should be reduced by a number of progressive reforms. Among these are removing the cap on wages subject to payroll taxes or subjecting investment income to OASDI taxes. Another option would be to use general revenues or a portion of the

federal budget surplus to bolster Social Security. Handling an extraordinary demographic event like the retirement of the Baby Boom generation is certainly an appropriate use of part of the surplus. While it is true that the recent tax cut legislation has reduced the long-term budget surplus, it is not too late for us to reconsider some of the more regressive provisions of that legislation. The Center on Budget and Policy Priorities reports that the long-term cost of the total tax cut is twice the size of the projected long-term shortfall in Social Security. Reversing the repeal of the estate tax, for example, would be a good first step towards securing the long-term health of Social Security.

Finally, we believe that this Commission should investigate the possibility of raising the earnings of the Social Security Trust Fund by investing payroll tax revenues in private sector assets. Rather than establish individual accounts, the Trust Fund could make collective investments on behalf all Social Security recipients and participants. Trust fund diversification is fundamentally different from replacing Social Security benefits with individual accounts. It is much more cost efficient than individual accounts and retains the unique risk- and cost-sharing features of Social Security – features that are not provided by the employer-based pension system.

Although I understand some are concerned about the federal government owning private sector assets and injecting politics into the capital markets, the 14-year record of the Thrift Savings Plan shows that it is possible to avoid this pitfall. Investments in index funds avoids the problems of picking winners and losers in the market, pools investment risks and reduces administrative costs to a minimum.

Thank you for the opportunity to testify today and I would be happy to answer any questions you may have.