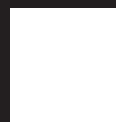
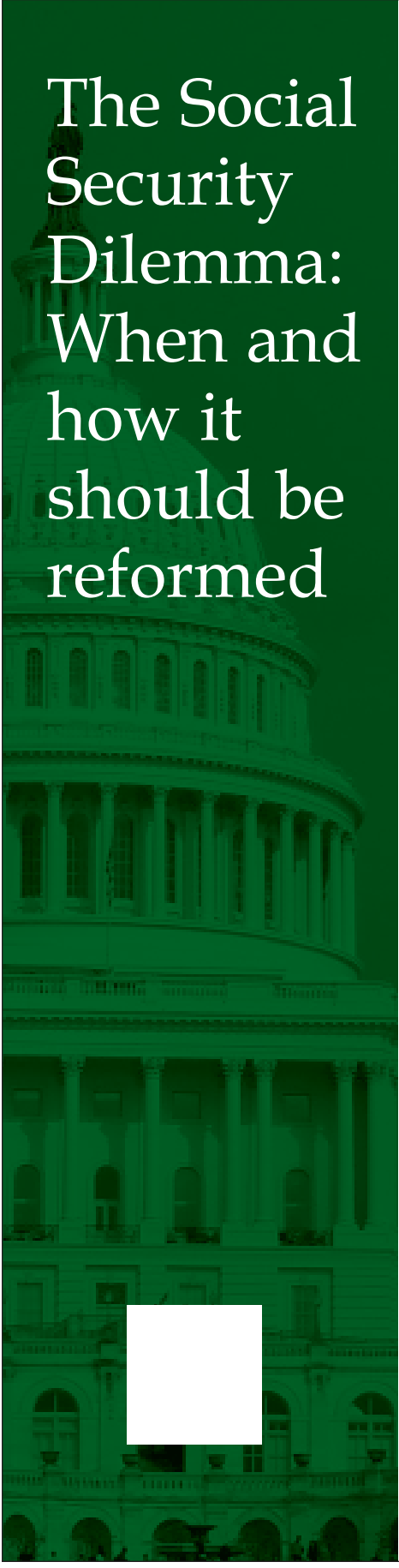




The Social Security Dilemma: When and How It Should Be Reformed

Is Social Security in trouble? If so, why? What reforms are most likely and when? Is a personal savings account a part of the solution or a problem? These topics and more are covered by nationally known experts.





The Social Security Dilemma: When and how it should be reformed

Introduction

One of the principal missions of Networks Financial Institute (NFI) at Indiana State University is promoting research on key issues confronting financial markets. There is probably no more important long-term issue facing financial markets, policymakers and voters today than the insolvency of the Social Security program and proposals to repair it. President George W. Bush began his second term in 2005 with a top priority of addressing the insolvency of Social Security. Initial political opposition and more immediate issues arising from hurricane destruction and concern for future risk diverted policymakers' attention from the debate in late summer and fall 2005, but there is little question that they will, sooner or later, return to the debate over how to fix Social Security. To foster that discussion, NFI sponsored a Financial Forum, "The Social Security Dilemma—When and How It Should Be Reformed," at the Columbia Club in Indianapolis on November 9, 2005. Three experts on Social Security reform took part, presenting the articles in this volume. The experts addressed the extent of the insolvency problem, including its cash flow and fiscal implications, not only for Social Security, but for the rest of the federal government as well. They also discussed alternative fixes, including the importance of holding down the cost of fixing the problem by addressing it sooner rather than later.

The speakers were Professor Thomas R. Saving, Mr. William Shipman and Dr. Jason Furman. Professor Saving is a Distinguished Professor at Texas A&M University and is the Jeff Montgomery Professor of Economics as well as the Director of the Center for the Study of Free Enterprise. He was appointed a Public Trustee of the Social Security and Medicare Trust Fund in 2000 by President Clinton. In addition, Saving was appointed by President George W. Bush as a member of the President's Commission to Strengthen Social Security and re-appointed as a Public Trustee of the Social Security and Medicare Trust Fund in 2005, subject to Senate confirmation. Mr. William G. Shipman is the Chairman of CarriageOaks Partners, LLP, and Co-Chairman of the Cato Project on Social Security Choice. He was formerly a principal of State Street Global Advisors and a founding partner of H.C. Wainwright. Jason Furman is a Visiting Scholar at the New York University Wagner Graduate School of Public Service and a Non-Resident Senior Fellow at the Center on Budget and Policy Priorities (CBPP). He has served as a Senior Economic Advisor to the Senior Vice President and Chief Economist at the World Bank and as a Special Assistant to the President for Economic Policy for the National Economic Council. He also worked as a Senior Economic Adviser and Policy Director for several presidential campaigns.

Professor Thomas R. Saving's article, "Social Security Reform: Can It Secure the Rights to Your Pension Benefits?" argues that, as currently constructed, it cannot, but a personal retirement account could do so. Saving explains that a currently projected funding gap, an excess of the current value of future benefit payments over future tax receipts and repayment of intergovernmental loans to the US Treasury, is not an illusion driven by the interest of some parties who favor one or another reform proposal. Instead, there is a real gap that is currently estimated by the Social Security Trustees to be \$12.8 trillion, which will have to be dealt with by the current or a future Congress. As Saving says, this gap will have to be made up by benefit cuts or tax increases, so that the issue is which generation is going to absorb the cost of fixing this gap, either the young who pay the greater taxes or the old who would absorb the benefit cuts. Professor Saving notes that the current gap will rise over time, so that, if it is not paid until later, it will cost more.

As Saving indicates, experts agree that, in the future, expected annual benefit payments will grow to exceed the dedicated annual tax revenue and the excess will also grow over time. Social Security Trustees estimate that benefits will exceed dedicated revenue after 2017. The Social Security Trust Fund is projected by the Trustees to last until 2041. Such a projection prompts some to believe that no reform is really required until then. But the Trust Fund provides no revenues to the Treasury after 2017, under current benefit and tax revenue scenarios; instead payments from the rest of the budget will be necessary to pay back the past annual intergovernmental



loan from Social Security to the Treasury. The absence of the earlier loans and then the outright payments to Social Security to allow continued payments of benefits until 2041 will require belt tightening elsewhere in the federal budget, again either tax increases or expenditure cuts. If the past is any indication of the future, benefit cuts or tax increases can be expected no later than 2022, or within 17 years, according to Professor Saving.

Professor Saving points out that the existence of the Trust Fund confuses many people, including political leaders. Since the system is required to invest its surpluses in special Treasury bonds, a trust fund surplus is simply a debt the government owes itself. The real danger of Trust Fund accounting is that it incorrectly fosters the belief that there is a Trust Fund solution to Social Security's insolvency. For example, some proposals call for the government to pay a higher rate of interest on the Trust Fund balance to the Social Security Administration or to simply issue more of these bonds, perhaps even \$12.8 trillion.

Such steps would not alter the problem. In particular, they would not affect the required tax increases or total government expenditure cuts that must be made to cover the \$12.8 trillion unfunded liability, according to Saving.

Saving explains that personal retirement accounts effectively "prepay" future benefits, reducing costs to future generations. There are two other important benefits. First, workers would become the explicit legal owners of their accounts, and second, their increased savings would increase the nation's income relative to the current scenario. Saving concludes that for all three reasons, namely, the restoration of solvency, personal ownership of retirement savings and increased saving, the introduction of such accounts offers a promising reform alternative. Unlike private pension arrangements with defined and legally protected future benefits, Social Security is exempt from ERISA, the law protecting defined benefits. Social Security participants have no ownership rights. According to Saving, "The real question is, how can we restructure Social Security so that participants have a real deal where, when the deal is violated, participants have standing in a court of law? An answer, and perhaps the only answer, is personal accounts where all participants have the funds in an accounts that they fully own."

In Professor Saving's view, any reform plan must address six questions:

- Who participates,
- Is the plan voluntary,
- Are participants paid for their accrued benefits,
- How do benefits in the reformed plan compare to existing (unpayable) benefits,
- Are there guarantees and, if so, are they real and what do they cost, and

- How much of the current unfunded debt is paid off by the reform?

Saving applies these questions to President Bush's proposals as an example. He explains that participation by older workers is prohibited, but anyone under age 59 in 2009 can participate, if they choose, by a one-time opt-in that allows them to put 4 percent of their Social Security taxes in private accounts, up to \$1000 per year. This limit or cap would grow each year by \$100 plus the rate of growth of national average wages. Workers who remain in the existing plan would receive benefits from a reformed and sustainable system that would not take away any accumulated benefits. However, benefits based on future wages would be limited by an indexing scheme that is based on price increases rather than wage increases.

New-plan participants would receive a Social Security benefit with the same annuity value as old-plan participants, except that theirs would be offset by an amount equal to the annuity value of an account that had earned the average real rate of return on ten-year government bonds. If their private accounts did not earn that much, they would receive the same benefits as under the reformed old plan with no offset, but they would surrender their private accounts to Social Security. If their private accounts earned more than this government bond fund, their Social Security benefit would be supplemented by their private accounts. In short, there is no reason not to participate in the new plan because the benefits under the old plan are always available as a last resort, and income from private accounts can only enhance the retirement income of beneficiaries. Under the Bush plan, the retirement benefit is not guaranteed, but Saving claims that the combined benefit from the new private account and from the new benefit plan could be expected to equal or exceed the currently scheduled benefit.

William G. Shipman argues in his article "The History and Future of Social Security" that demographic realities and the financial promises of the pay-as-you-go Social Security system are on a collision course, exposing the flaw in Social Security plans in the US and abroad. He claims that a switch to a governmentally overseen plan that is otherwise private would avoid the collision and pay superior benefits to current and future generations. In Shipman's view, Social Security is in trouble today around the world largely because it is inappropriately based on an insurance model rather than a saving and investment model. The insurance model breaks down when the insured group is subject to a common event shared by everyone, in this case, the payout of retirement benefits. Under this scenario, risk cannot be transferred to the rest of the group. Everyone retires, so risk cannot be transferred from the affected to the unaffected. Annual premiums must be enough to pay for the common experience of the large group, in this case its common retirement income. Were it not for the bulge of baby-boomer retirees, or the low birth rate, this failure of the insurance model would not have been so inevitable, Shipman sug-



gests, but the system would still have been inefficient.

The global response to financial shortfalls has been to raise taxes. As Shipman explains, politicians tend to see the Social Security problem as one of cash flow, with too many benefits relative to too few taxes. The responses are then myopic: raise taxes, cut benefits, or both. Raising taxes spreads the cost over more voters than cutting benefits would, so the cost per person is lower with a tax increase, making higher taxes the first resort. Eventually this strategy hits a political wall, and then benefit cuts are pursued. To do this but mask its implications, politicians resort to code words: “progressive price indexing, longevity indexing, adding a third bend point, reducing bend point factors, increasing the NRA, decreasing the PIA, and it goes on and on. It’s all code for cutting benefits.”

Shipman explains that a market-based system with competition would be more attractive. In his view, such a system would allow workers to invest part of their payroll tax in professionally managed and highly-diversified portfolios. Shipman has developed a market-based investment and administrative plan based on the 401(K) model as an option for Social Security. Its eight objectives are:

- Create individual accounts, with assets owned by the account holder;
- Ensure reasonable cost for low- as well as high-income workers;
- Minimize employers’ administrative burden;
- Provide the opportunity for all workers to invest in capital markets;
- Ensure that inexperienced or poorer investors will not suffer relatively poorer returns;
- Provide investment choice;
- Offer a solution for workers who make no investment choice;
- Automatically adapt to changing technology and services offered by the financial services industry.

Defined contribution plans based on the 401(K) model have increased in popularity since the late 1970s. Initially these plans had limited investment opportunities, perhaps a value fund and stock in their own company, but there has been an explosion of opportunities in more recent years, with less emphasis on company stock and new diversified alternatives allowed by new investment technologies. The biggest obstacle to conversion of Social Security to a 401(K) model is, according to Shipman, the current record-keeping system, because it limits the timely posting of individual savings contributions to their accounts.

To solve this problem, Shipman proposes a three-tiered system of investment options that, first, invests a worker’s saving in a collective money market fund; later, the individual can decide whether to invest in,

and select, one of three balanced funds offered through the Social Security system. This second step requires that Social Security be able to isolate the savings of a worker in such an account, after a period of about one year. After a period of about three years, to allow time to build an appropriate scale of account balance, an individual could then transfer their personal account to retail retirement account which meets safety and diversity criteria set by Social Security.

Shipman explains that the administration of such an individual account system would require the development of a large-scale, customized record-keeping system with the capability to produce a highly efficient service solution. The efficiency of the service application would be dependent upon the design and execution of the system. There is no existing application that meets all the requirements. Studies by Shipman and colleagues at State Street Global Advisors estimate that the long-run cost as a percent of assets would be 19 to 35 basis points, or 0.19% to 0.35%, which compares favorably to Social Security costs today or to the cost of most mutual fund accounts. Shipman says that the results of his studies show that a market-based competitive system provides enhanced and privately-owned benefits and that these benefits could be quite affordable.

Jason Furman, in his paper "Encouraging Financial Security: First Do No Harm," agrees that Social Security reform is necessary and that acting sooner is better than later. He also notes that the principal problem is not just the baby boomers' retirements, because the large unfunded deficit will grow even after all the boomers are dead. He suggests that the problem is really the "baby bust," the sharp decline in fertility that will keep tax receipts growing more slowly than benefits under current tax and benefit formulas. He argues, however, that the Bush plan was unsuccessful because it did not meet four goals that any reform must accomplish: restore solvency, address the long-run and short-run budget deficit, strengthen retirement security and boost national saving. Thus, in his view, the plan violates the Hippocratic standard for intervention: first, do no harm. Furman also evaluates the idea of replacing the President's personal accounts that are based on a "carveout" from existing social security taxes with personal accounts that are based on "add-ons" or accounts that require saving in addition to social security taxes. Finally, he outlines an alternative approach developed by Peter Diamond and Peter Orszag that, Furman says, restores Social Security solvency and encourages new saving by moderate income families.

Furman says the Bush plan involves two parts: voluntary private accounts and sliding-scale benefit reductions based on a plan developed by Robert Pozen called "progressive price indexing." The sliding-scale reductions in benefits would begin in 2012 and increase over time.



The plan allows workers, at their discretion, to divert some of their payroll taxes (up to a maximum) into individual accounts. Furman claims that the President's plan would lead to permanently higher government debt because of the personal accounts. Furman estimates that the President's proposal will greatly diminish Social Security benefits and that income from private accounts will not fully offset the reductions.

According to Furman, the President's personal accounts do nothing to raise national savings and could even result in lower savings. He admits, however, that the benefit cuts in the President's plan could lead to small increases in savings over time, but not immediately and not by enough to pre-fund Social Security. Furman implicitly assumes that a positive rate of return on the personal saving account contribution will not boost private saving by more than the implicit borrowing that could be required by the reduction in Social Security receipts. In his view, "carve-out accounts" would reduce Social Security solvency, reduce retirement security and potentially reduce national savings. But he also criticizes proposals for "add-on accounts" relying on tax incentives that could be financed by increasing the debt, because they would also be counterproductive and harmful, in his view.

An alternative plan that Furman considers is one developed by Diamond and Orszag (*Saving Social Security*, Washington DC: Brookings Institution Press, 2003), which Furman maintains would advance all four of the goals he enumerates. Their proposal is to address increased life expectancy by a combination of benefit reductions, tax increases and later retirement. They would also adjust for increased earnings inequality by gradually raising the ceiling on the income level where Social Security taxes are paid. They would share "legacy" debt, the inherited debt that is currently owed to existing and past workers for promises based on their past earnings, by further benefit cuts and tax hikes combined with a "legacy charge" on future earnings above the payroll tax cap. They would also raise benefits for widows and raise the minimum benefit.

Furman emphasizes that a lack of national saving is a part of the Social Security problem facing the nation. Increased saving would foster investment and increased future output, lessening the painful future pressure to reduce the consumption of the young in order to pay for the consumption of the old. Furman proposes that saving should be made easier and more rewarding by automating 401(k) savings, simplifying the process for families to contribute their tax refunds to IRA accounts, reducing penalties on low-income families for their saving (by reducing welfare benefits) and increasing the rewards to low and middle-income families for saving.

There is a wealth of information in the three articles here, but clearly there are critical outstanding issues. It will likely come as a surprise to many readers that these experts agree on the fact that there is such a large unfunded Social Security liability for retirement and disability benefits, and that the program is insolvent, and that the cost of delaying action on reform is large. The Congressional Budget Office (CBO) studies of the problem are in broad agreement with Saving's estimates of the problem and the effect of postponing action. The CBO estimates that under current scenarios for the future, Social Security benefits will have to be cut by 26 percent starting in 2041 if no action is taken before then. And future benefit reductions will grow larger subsequently.

Saving's estimates of the timing of significant budgetary effects may be too sanguine because the annual Social Security Fund surplus may have peaked in 2002, according to subsequent data and Social Security projections. It is likely to fall from now on, even before this surplus disappears in 2017, the point at which Congress will have to find larger and larger cuts in other spending or increases in taxes to fund the Social Security problem. The future, in other words, has arrived and we are already facing the budgetary implications of the insolvency of Social Security. Eventually the annual adjustment will become massive.

In their remarks, the panelists disagreed on whether personal retirement accounts would increase or decrease national saving and on whether low-income persons would benefit adequately from them. They also expressed diverging views on the risk associated with personal accounts and the effects on the overall budgetary position of the federal government. Implicitly there was some agreement that tax hikes and benefit increases could provide periodic fixes to the problem, but the numbers required for this case were not laid out by any participant, nor was the overall cost. Finally, the three panelists each presented criteria for assessing reforms. Each set was different and no effort was made to debate their relative merits. Nonetheless, each set could prove useful in attempting to move toward future agreement on reform. And the three sets may provide the outlines for a consensus set of reform requirements. Shipman's practical discussion of a plan to implement and administer a personal account shows that this can be done and accomplished relatively cheaply. This is a key finding for proponents of a personal account. Together with his claims about the attractiveness of the returns and ownership security, Shipman provides a strong case for going beyond the President's plan and therefore, implicitly, for going at least as far as that proposal.

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Social Security Reform: Can It Secure The Rights To Your Pension Benefits?

Thomas R. Saving
Introduction

Social Security has been an extremely popular program over its 70 years of existence. It has provided retirement, life insurance and disability benefits to workers and their families. Through the years, benefits have been expanded and adjusted, new groups of workers have been covered, and taxes have been raised on workers and some retirees to pay for the program's costs. As the program's costs grew, so did its revenue base, as members of the Baby Boom generation matured and reached their peak annual earnings. For the past 20 years, Social Security payroll tax revenues have been in excess of its benefit payments, providing revenues to the Treasury to fund other programs.

The program's surpluses are expected to end in 2017. In all future years, its costs, in the form of benefit payments, will exceed its dedicated tax revenues and the gap between cost and revenues is expected to grow each year into the indefinite future. Anyone looking to provide for the continuation of Social Security must deal with this growing funding gap. The projected funding gap is not an illusion made up by those who favor one type of reform over another, but a real gap that must and will be dealt with by the present or some future Congress.

The Social Security reform debate is really about how to close this gap – essentially how to provide retirement benefits to current retirees as they age and how to provide benefits to new retirees in the very near future. But how future benefits are funded, whether through future tax increases or through additional savings today, determines who bears the burden of closing the

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The views expressed are those of the author and do not necessarily reflect official positions of Networks Financial Institute. Please address questions regarding contents to Thomas R. Saving at t-saving@tamu.edu. Any errors or omissions are the responsibility of the author.

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funding gap and when that burden is borne. Most reformers have as their goal the provision of benefits comparable to the benefits that are currently scheduled. In the present paper, I would like to explore how personal retirement accounts provide one avenue to achieving reform.

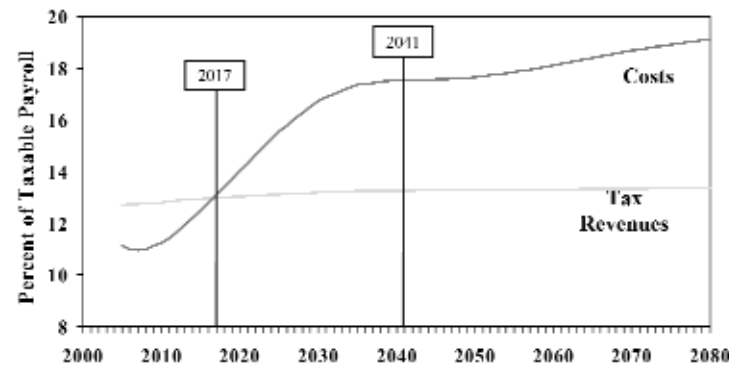
The Nature of the Problem

The fundamental problem facing Social Security is summarized in Figure 1, below. Most of those familiar with Social Security know that, beginning in 2017, its costs, in the form of benefit payments, will exceed its dedicated tax revenues. The gap between costs and revenues grows in every year thereafter.¹ The present value of the difference between projected costs and revenues over the indefinite horizon is \$12.8 trillion. Closing this financing gap is the task of all reformers.²

Before going any further, I must note that some opponents of reform at this time argue that the system is sound until the Trust Fund is exhausted in

Figure 1

Projected Social Security Costs and Revenues (OASDI)



Source: 2005 Trustees Report (OASDI), Table IV, B1.

2041 and even then, 72 percent of current benefits could still be paid. They are absolutely correct in asserting that the Trust Fund would last until 2041 if currently scheduled benefits are actually paid and only currently scheduled taxes are collected. However, the payment of scheduled benefits requires that a significant share of general revenues be used to pay Social

1. This greater debt is due to a combination of two events that are occurring worldwide: a population bulge known as “baby boomers,” and increased longevity. These two events have allowed the taxes required to fund the retirement of past retirees to be woefully inadequate to fund the much larger retirement population soon to be in place. Even though the “baby boomers” will ultimately pass through the system, their passing does not solve the problem as falling fertility and increased longevity are sufficient to insure that workers per retiree will continue to fall.

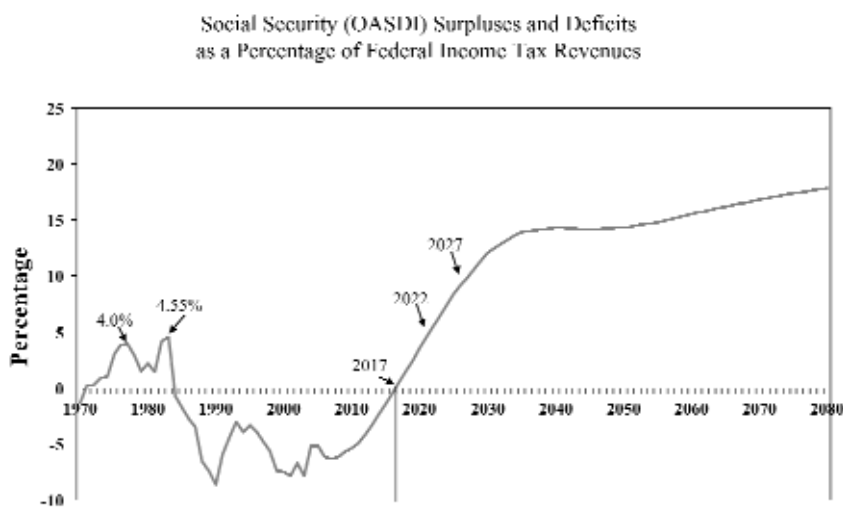
2. In this calculation the \$1.7 trillion Trust Fund is not considered as an asset. If it were, the debt would be \$11.1 trillion. See the 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Security benefits rather than finance normal federal government programs. Thus, while the Trust Fund is projected to last until 2041, in a budget context, the Trust Fund provides no revenues to the Treasury, so that its redemption to pay benefits will require belt tightening elsewhere. The actual budget implications of the projected Social Security deficits are completely independent of the size of the Trust Fund or even its existence.

Given that there is general agreement that the Social Security system must be fixed, what is the solution? Can't we just stay with the current system? To put this last question into perspective, consider the following. In just 12 years, payroll taxes will fall short of what is needed to continue paying Social Security benefit checks. At that point, the Treasury must begin transferring funds from general revenues to Social Security. The transfers will increase rapidly so that by 2022, the transfer will reach the equivalent of five percent of total federal income tax revenues, implying that between now and 2022, Congress will lose the equivalent of 12 percent of total federal income tax revenues to Social Security. What, if anything, does this lost revenue portend for Social Security?

Figure 2 shows the past history of Social Security surpluses and deficits as a percentage of federal income tax revenues. In 1978, the payment of Social Security benefits required a general revenue transfer of just over four percent of federal income tax revenues. The response of Congress to this

Figure 2



transfer was to change the benefit formula, effectively reducing scheduled benefits for future retirees. The positive effect of this change was short-lived so that by 1983, the system once again required large general revenue transfers to pay benefits. The 1983 general revenue transfer was approximately



four and one-half percent of income tax revenues. Once again the response of Congress was to cut benefits, by making Social Security benefits subject to income taxation. In 1983, Congress also raised taxes and increased the retirement age. Importantly, in 2022, just five years after Social Security has its first deficit since 1983, the Social Security system will require greater general revenue transfers than Congress has ever allowed before cutting benefits and/or raising. If the past is any indication of the future, we can expect benefits cuts or tax increases no later than 2022, in just 17 years.

The Implications of Staying in the Current System

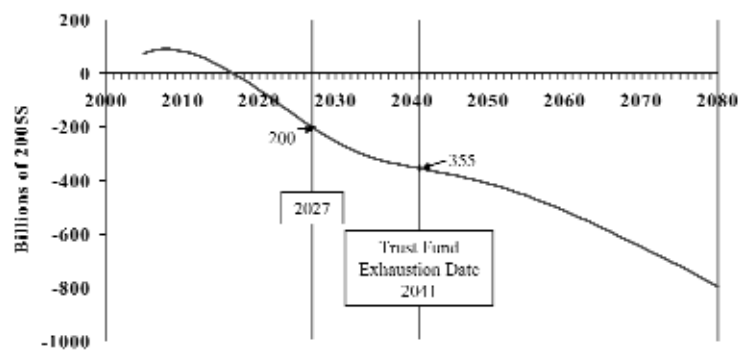
The long-run forecasted imbalance between payroll tax rates and benefit levels will cost the nation an additional \$12.8 trillion in today's dollars to keep the current benefit structure in place. The unpleasant truth is that if we pay promised benefits and only collect scheduled taxes from the current generation, the next generation will have to come up with \$13.7 trillion rather than the \$0.8 trillion they are scheduled to contribute under current law. The current funding arrangement implies large obligations that the system cannot pay without reform. Thus, the current system has its own very significant "transition costs."

Remaining in the current system entails finding the revenue to pay the scheduled benefits. There are two ways to find the revenue to pay these benefits: (a) allow the payroll tax rate to rise to cover benefits; (b) use general revenues to augment payroll tax receipts. Figure 1 shows the payroll tax rates that would be required to pay the scheduled benefits. Once 2017 is reached, payroll tax rates must rise rapidly from their current level of 12.4 percent to 14 percent in 2020, just three years after the system experiences its first deficit, 15.5 percent just five years later in 2025, and 16.75 percent in another five years, in 2030. These payroll tax rate increases, if implemented, can be expected to have serious effects on labor force participation rates that will require that the revenue estimates in Figure 1 be revised downward.

If general revenues are used to augment payroll tax receipts, then other taxes must rise or federal expenditures must fall. Figure 3 shows the dollar transfers that must be made from general revenues to pay scheduled benefits. Just ten years after the system experiences its first deficit, \$200 billion 2005 dollars must be transferred from general revenues to Social Security if currently scheduled benefits are to continue being paid. Moreover, by the year of forecast Trust Fund exhaustion, 2041, the general revenue transfer will grow to \$355 billion 2005 dollars. Transfers of this magnitude imply that Congress will be giving up discretion over more than 15 percent of all federal income tax revenues.

Figure 3

Social Security Surpluses and Deficits 2005\$



Source: 2005 Trustees Report (OASDI).

Why Not Continue to Invest the Surpluses in Special Issue Trust Fund Bonds?

Since the system is required to invest its surpluses in special issue bonds, the trust fund is simply a debt the government owes itself. While from the perspective of the Social Security system, separate from the rest of government, the Trust Fund is an asset, the ultimate redemption of the Trust Fund requires that the Treasury provide the funds from government revenues. This relation of the Trust Fund to the overall budget has been well understood, as the following statement from the Budget of the United States Government made during President Clinton's administration shows:

These [Trust Fund] balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits.

Analytical Perspectives, Budget of the United States Government, Fiscal Year 2000. p. 337.

In effect, the Trust Fund is a bit like the government's left hand writing its right hand a billion dollar bond and then the right hand claiming that it is rich. The real danger of Trust Fund accounting is that the public or Congress may be misled into believing that there is a Trust Fund solution to Social Security's future financial shortfalls. Concentration on the Trust Fund

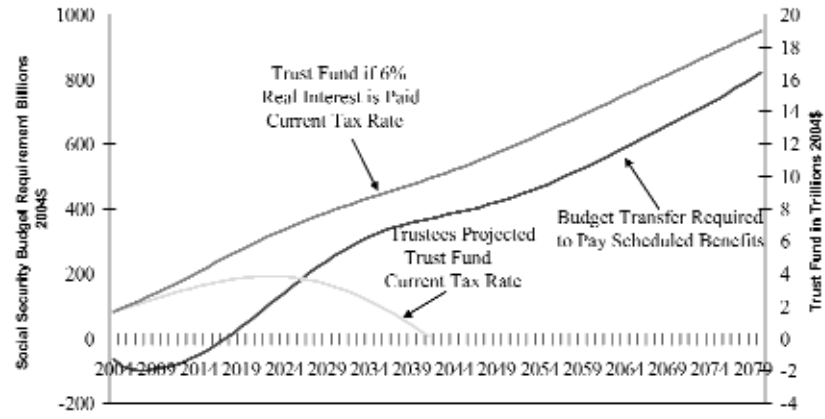


gives credence to a solution that would, for example, increase the interest rate paid on the Trust Fund from its current level of the average rate of interest on government debt of 10 years and under, to a six percent real (inflation adjusted) interest rate. Indeed, from the perspective of the official definition of solvency, Social Security would be solvent into the indefinite future. But as depicted in Figure 4 below, the general revenue transfers necessary to provide currently scheduled benefits would remain unchanged. Thus, while after the increase in interest payments credited to the Social Security Trust Fund it would never be exhausted, from the perspective of the total

Figure 4

federal budget, nothing would have changed.

Social Security Budget Requirements and the Trust Fund Balance



Why Private Accounts?

To understand the merits of private accounts, we must first understand the level of security provided by the current system. Because of concerns about pension systems in the private sector, in 1975 Congress passed the Employee Retirement Income Security Act (ERISA). This act provided for the oversight of private pension plans and required certain funding and vesting provisions. Importantly, Social Security is exempt from ERISA. Or perhaps, it is treated the way many private defined benefit plans are treated. Firms in financial duress are allowed to stop payments into these plans temporarily, resulting in these plans being unfunded or underfunded. Note that any private plan that is based on defined contribution rather than defined benefit does not suffer from this same potential underfunding risk. This distinction is critical when we consider Social Security reform. Defined benefit plans are essentially common property, meaning that all participants own them in common rather than each individual having individual ownership of specific part of the assets. Defined contribution plans are totally individually owned. Once the funds are in an individual's account, they are untouchable by the firm.

In contrast to private defined contribution plans, Social Security participants have no ownership rights. In effect, as a Social Security participant you have a contract with your Congressman or Congresswoman, the terms of which give them the right to change the contract whenever they like and you have to accept whatever terms they set. Such an agreement would violate both the spirit and literal interpretation of ERISA rules.

The real question is: How can we restructure Social Security so that participants have a real deal where, when the deal is violated, participants have standing in a court of law? An answer, and perhaps the only answer, is personal accounts where each participant has the funds in an account that they fully own. This ownership must not be at the whim of Congress, even though the use of the funds before retirement or death may be restricted; once retirement or death occurs, the funds become exactly as any other property.

Comparing Social Security Reforms

There are a number of reform plans for Social Security; what is needed is a general approach to comparing these plans. Such a comparison must recognize that staying in the current system is not an option, since the current system is unsustainable. There are six questions that the proponents of any reform should answer. First, who participates in the reformed system? Second, is participation voluntary? Third, are participants compensated for accrued benefits? Fourth, how does the reform benefit structure compare to current Social Security's promised benefits, even though these benefits cannot be paid by the current system? Fifth, are there any guarantees, and if so, what do they cost and is the guarantee real? And finally, sixth, how much of the current Social Security debt does the reform pay off?

In light of these six elements and as a frame of reference, let me consider a proposed Social Security reform based in a general way on the parameters suggested by President Bush. The principle elements of this proposed reform answer each of the six questions posed above:

- First, all individuals currently 55 years and older must stay in the old system.
- Second, participation is voluntary, at any time workers can "opt in" by making a #³ *one-time* election to enter the new system. Beginning in 2009, individual participants under age 59 will be allowed to invest 4 percentage points of their Social Security taxes in private accounts up to \$1,000 per year. The \$1,000 cap on contributions will grow \$100 per year,

3. The 2001 *President's Commission to Strengthen Social Security* suggested that private accounts offset some of the accumulated debt. More importantly, however, the Commission also suggested that rather than replace a constant share of wage indexed earnings, the defined benefit part of Social Security provide a fixed level of purchasing power for all income groups. This change alone reduces the outstanding debt to existing generations and significantly reduces funding requirements for both new and current generations.

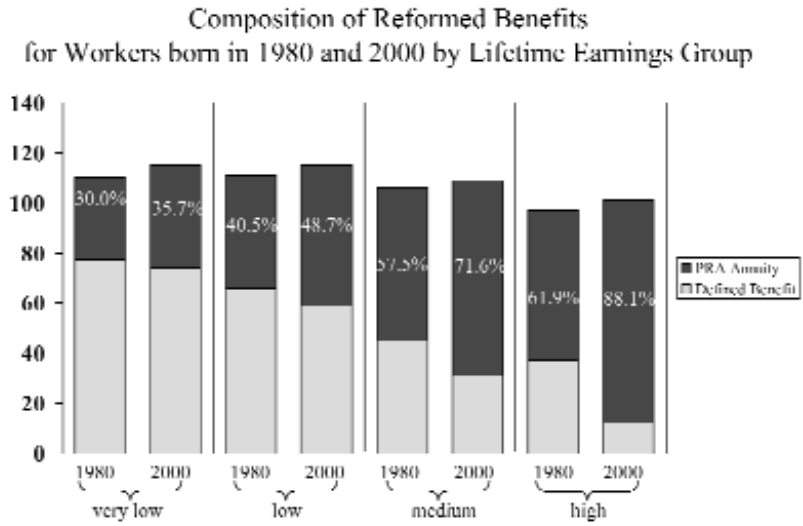


plus growth in average wages. In return, those electing the new system will give up some of their currently scheduled benefits via progressive price indexation, where low income benefits will be fully wage indexed while high income benefits will be fully price indexed.

- Third, those who stay in the existing system will draw benefits from a reformed and sustainable Social Security system.
- Fourth, at retirement, the annuity value of an account that earned the average real rate of return on ten-year government bonds offset the individual's defined benefit payments unless the private account did not achieve the offset rate of return. In that case, the personal account is turned over to Social Security and no defined benefit offset occurs.
- Fifth, the total retirement benefit is not guaranteed, but the combination of the private account and the new defined benefit can be expected to equal or exceed currently scheduled benefits for all income classes.
- Sixth, a reform based on the President's outline will result in a Social Security system that is sustainable. In fact, with this reform the system goes into surplus in 2055 and the surplus rises each year thereafter. The President's reform pays off \$3 trillion of the \$13 trillion current Social Security debt.

This augmented President's plan results in a dual system, part of which is a personal account and the remainder is a defined benefit, just as is the current Social Security. One of the goals of the President was to maintain the same benefit structure as current Social Security. As shown in Figure 5, which shows the composition of benefits for four income groups and birth years 1980 and 2000, as the reformed system matures it achieves exactly that, at least in an expected value sense. Once the system reaches the point

Figure 5



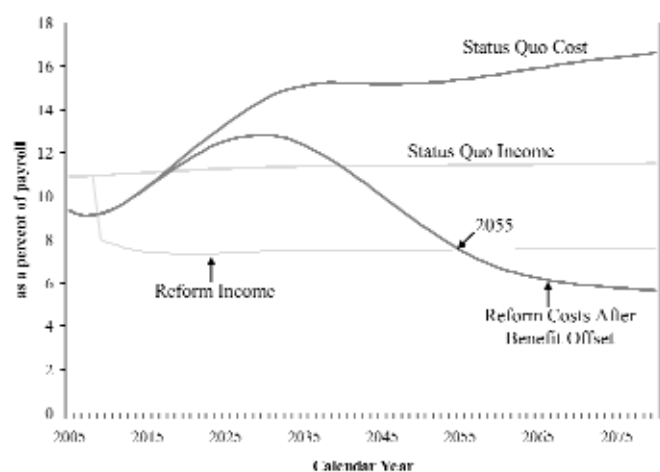
where all participate, those born in 2000 and after, the President's plan returns full scheduled benefits for all, and even more for low income participants, with one caveat that will be discussed more fully below. Figure 5 also shows that as the system matures, a greater and greater proportion of total benefits are paid from personal accounts. The percentages reported in the figure are based on expected values. As a result, because the very low lifetime earnings participants are fully wage indexed, the actual defined benefit for this group would remain at 100% of currently scheduled benefits, even if their private accounts earned nothing.⁴

Another point to bear in mind is that the combination of the four percent accounts proposed by the President and complete price indexation of benefits for higher income participants will in the long run produce benefits for the highest income group that will fall below currently scheduled benefits.⁵ Actually, under the rate of return assumptions used here, the private account contribution would have to be 5.4 percent of payroll to maintain expected benefits equal to the benefits currently scheduled for the long run. However, as I show below, the system here goes into surplus in 2055, and the surplus could be used to increase the contribution rate until the 5.4 percent level is reached.

If a reform is to address the solvency problem for the long run, it must be the case that the system revenues under the reform eventually become

Figure 6

Annual Revenues and Costs of OASI with and without Reform



Source: 2005 Trustees Report and author's estimates.

4. The so-called progressive indexation results in some additional redistribution from higher to lower income individuals. However, the current system is less progressive than it might seem from highly redistributive benefit schedule due to a positive correlation between lifetime income and longevity. According to Garrett (1995), differences in mortality considerably narrow, and in some cases eliminate, the progressive spread in returns across income classes. Liu and Rettenmaier (2003) also reached a similar conclusion by studying both the rate of return and the present value of the Social Security investment for different racial and education groups.

5. Given positive income growth, fixing the real defined benefit results in the highest income group defined benefit going to zero in the limit as the ratio of prepaid benefit to defined benefit goes to zero.



equal to or greater than the cost of any scheduled benefits. Figure 6 shows the forecast revenue and cost of benefits for the reform, based on President Bush's proposals. The lower cost line is constructed assuming that private accounts achieve the expected return for a 60% equity - 40% bond portfolio.⁶ Based on this rate of return, the individual accounts offset scheduled benefits so that the system has a positive cash flow beginning in 2055, with the surplus growing each year thereafter.

The design of the Social Security system was to give participants a legal right to their benefits. Unfortunately, a system with Congress as one party to the contract cannot be legally secure. What reform can change the nature of this contract? Only personal accounts can give participants a legal right to their pension benefits. With personal accounts, participants would have standing in a court of law should Congress attempt to change the terms of the Social Security system.

Transition Costs

The previous discussion provides the backdrop for understanding transition costs. Recent media reports have stated that the transition costs of the personal retirement accounts reform, favored by the president, amount to between \$1 and \$2 trillion. What exactly do these estimates quantify? Do transition costs quantify the costs of shifting from the current financing arrangement to a partially prepaid system?

Prepaying Social Security partially or totally simply changes the timing of the financial burden and thus changes the generational burden of the program. However, if the goal of the reform is to pay scheduled benefits as depicted in the graphs, then the present value of those scheduled benefits is the basic cost of the program. Since the current financing arrangement cannot pay these costs, the system must be reformed, but the costs are the same for all reforms. As pointed out above, an important distinguishing characteristic of reforms is in the way they distribute the burden of the program across generations.

With a personal retirement account reform, workers save more and accumulate a fund from which they will purchase an annuity. The goal of most reforms is for the sum of the annuity and the reformed defined benefits to equal the benefits that are currently scheduled. Thus, the reforms do not reduce the total combined benefits retirees will receive. However, the reforms do reduce the share of total benefits that will be paid by future taxpayers, and as a result, future taxpayers have a lower burden than they would if all benefits had to be paid for through contemporaneous tax payments.

6. Specifically, the accounts are assumed to be invested in 60 percent stocks, 24 percent corporate bonds and 16 percent government bonds while workers are between 21 and 57 years of age. The assumed real rates of return are 6.5, 3.5, and 3.0 percent, respectively. The share of stocks begins to decline at age 57, reaching 20 percent by age 62.

How the personal accounts are funded determines the ultimate generational burden of the reform. Specifically, if individual contributions are required or additional tax revenues are raised to fund the accounts, then the current generation of workers will carry some of the load. If the accounts are fully funded using borrowing, most of the burden will be borne by future workers. Importantly, in either case the reform will solve Social Security's long-run solvency problems.

Some Concluding Remarks

All Social Security reforms must deal with the fact that benefits, as currently scheduled, cannot be paid with the current tax rate. Comparing reforms essentially boils down to identifying how different generations will be affected. In addition to reducing the burden on future generations, prepayment with personal retirement accounts has two other collateral benefits. Workers become the owners of their retirement accounts, and increased savings will increase the nation's income relative to the current financing arrangement. For these reasons, such reforms offer a promising alternative in the current policy discussion.

Finally, when coupled with the pending Medicare shortfalls, we must find a way for the working generation to pay for some of their retirement consumption while they are working. If we pay current law benefits for Social Security and Medicare and only collect current law taxes and premiums, the shortfalls will use up large parts of future federal income tax revenues. Within just fifteen years, in 2020, we will have to transfer more than 29% of federal income tax revenues to the combination of Social Security and Medicare. The problem worsens rapidly so that just ten years later, more than one half of all federal income tax revenues will be consumed by Social Security and Medicare. Clearly, these transfers cannot and will not happen. The real issue is, how will these programs be changed? The establishment of personal accounts as part of the reform of Social Security can form the basis for beginning the prepayment of all retirement benefits.



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The History and Future of Social Security

William G. Shipman

Eleven years ago I had the opportunity to testify to Congress concerning Social Security. I started my formal comments with the following:

As both a son and a father, I am interested that the elderly are well cared for, and that the young have the opportunity to build sufficient assets so that they, too, can retire in dignity. Social Security, as presently structured, ultimately will achieve neither objective. Although compassionate in its original intent, it is flawed in design.

The system's financial structure is fundamentally unsound. Legislation of 1977 and 1983 attempted to address this by raising taxes and cutting benefits; Social Security was to be on sound financial footing well in to the 21st century. And now, just a few years later, The 1994 Board of Trustees' report suggests that the system will run out of money seven years earlier than it projected just one year ago. Legislative initiatives to reduce benefits further and raise taxes are again on the drawing board. This did not work in 1977 or 1983; it will not work now. Social Security's financial integrity requires an entirely different approach. I offer this testimony in the spirit of the starting point for an alternative: a concept of privatization wherein Americans benefit from the engine of a free economy and free choice. With privatization properly structured, today's elderly will be protected, the young will retire with higher incomes, and our political leaders will have offered, once and for all, a lasting solution for which all voters will be thankful.

** This paper draws on two of the author's written testimonies to the United States Congress*

The views expressed are those of the author and do not necessarily reflect official positions of Networks Financial Institute. Please address questions regarding contents to Jason Furman at jason.furman@nyu.edu. Any errors or omissions are the responsibility of the author.

About the Author: William G. Shipman is Chairman of CarriageOaks Partners LLC, a Massachusetts-based consulting firm specializing in retirement finance. An advocate of Social Security reform in the United States, Mr. Shipman has co-authored *Promises to Keep: Saving Social Security's Dream*. He is Co-Chairman of the Cato Project on Social Security Choice, and was on the National Advisory Board of "Americans Discuss Social Security," a non-profit organization funded by the Pew Charitable Trusts to generate informed debate on the issue. He also has testified before the House Ways and Means Sub-Committee on Social Security and served as a delegate to the White House Conference on Social Security. His research has been published by the *Financial Analysts Journal*, *The Journal of Investing*, *The National Center for Policy Analysis*, *The Heritage Foundation* and the *Cato Institute*, as well as numerous other publications, and was commended for one of its outstanding papers by *The Journal of Investing*. Mr. Shipman has discussed and debated public policy issues before the United Nations and both the Joint Economic Committee and House Budget Committee Task Force on Social Security of the United States Congress. Prior to establishing CarriageOaks, Mr. Shipman spent more than 30 years in institutional financial research and consulting. He was a principal of State Street Global Advisors, a founding partner of H. C. Wainwright Co., Economics, and a general partner of H.C. Wainwright & Co. Mr. Shipman received his degree in psychology from Syracuse University.



Since that testimony, our nation has had a vigorous and open discussion. Many new ideas have been offered, ideas not developed prior to 1994. The climate of opinion has changed; more Americans are now aware of the issue, more Americans want the option to save and invest for their own future. We are getting closer to the point where the “rubber meets the road,” when time is running out on the existing system.

Unfortunately, over the intervening years little has changed politically; we’re still talking about raising taxes and reducing benefits. We have wasted precious time.

A Collision Course

Like other nations, we face an unprecedented challenge of how to deal with a reality that humankind has never confronted before and one that most people are unaware of. How we and other governments respond will affect each American citizen, our families, businesses across the land, indeed our very way of life. The reality is not only unprecedented, it is unyielding.

Dr. Karl Otto Pohl, former president of the German central bank, the Bundesbank, stated it this way: “In a relatively short period, we must adapt our domestic institutions, international relationships, and even our individual life plans to a new and powerful reality.”

What he was speaking of, and what confronts each of us here, is the fact that there are two powerful forces on a collision course. The first is the aging of society, the reality that the elderly population is increasing more rapidly than the population as a whole. In America, but even more so in other countries, the elderly rely on Social Security to survive financially. Should Social Security falter, many elderly will be destitute.

The second force is that most Social Security systems, including ours, are, in fact, failing. They are financially unstable, and not sustainable as they are presently structured.

The challenge is to avoid the collision of these two forces. In my view, the risks are high that we will not. But should we prevail by structuring a lasting solution, the rewards will be as unprecedented as the challenge itself.

The Early Years: Social Security’s Roots

Social Security was enacted in 1935 during the Great Depression. During the first half of the 1930s, real GDP fell by about 25 percent, unemployment jumped to 22 percent and the stock market virtually imploded and fell about 70 percent. Our nation was on her economic knees. President Roosevelt had

to do something, something big, but large government programs were anathema to the frontier spirit of our young nation. In order to achieve his goals, he needed unprecedented authority. To grasp that authority, he went before the nation on March 4, 1933 in his first Inaugural Address and asked for authority "... as great as the power that would be given me if we were in fact invaded by a foreign foe." He achieved his goal and ushered in Social Security, the flagship program of the New Deal.

Much like other Social Security programs that preceded ours, the first being Germany's in 1889, benefits paid to the elderly were financed by payroll taxes. In our case, during the Great Depression, people who had jobs were considered the wealthy. It wasn't like today wherein Americans have portfolios of stocks and bonds, real estate, defined benefit and contribution plans and the like; you were considered wealthy if you had a job. And needs were so urgent that the "payroll wealth" was taxed. A saving and investment structure would not have worked at that time because it takes time to compound investment returns to accumulate wealth, and time was short.

Today: A Fundamentally Flawed Program

Over the decades, however, this sort of urgent safety net has turned into the rough equivalent of a defined benefit plan. Yet its financial structure has not advanced. The Old-Age and Survivors Insurance part of Social Security, as its finances are presently structured, is inefficient, financially unsound and fundamentally flawed.

Because benefits are paid by taxing payroll, benefits can increase by no more than payroll increases, assuming that the tax rate on payroll is held constant. Over the last four decades or so, payroll has increased by about 1.5 percent per annum in real terms. That is roughly equivalent to saving and investing and receiving a rate of return of 1.5 percent. To put this into perspective, if one were to save \$1,000 each year for a 45-year working career and earn 1.5 percent, the saving would accumulate to about \$64,000. During the last 79 years a mixed portfolio of 90/10 percent large/small company stocks earned an inflation-adjusted average annual return of 9.7 percent. One thousand dollars invested annually for 45 years earning that return would accumulate to about \$650,000. And a conservative portfolio of 60/40 percent stocks and bonds, respectively, would accumulate to about \$288,000. These different values give a glimpse of the lost opportunity that our citizens incur by being required to finance their retirement through payroll taxes.

But it is worse. For any particular age group, it matters how many workers pay taxes relative to the number of retirees who receive benefits. The change in this ratio is largely determined by the change in national wealth, or GDP per capita. As national wealth rises, life spans also rise. We observe this



not only here but across all parts of the globe. When Social Security was enacted, life expectancy at birth was 61 years of age; it is now about 78. In the post-war period global life expectancy has increased from 45 to 65 years of age, a greater increase in the last 50 years or so than in the previous 5,000 years. This is all new. We didn't expect it. But now we think it will continue.

Also, as nations become wealthier, birth rates fall. In many countries they have fallen below the population replacement rate of 2.1. The combination of rising life expectancy and falling birth rates causes havoc with pay-as-you-go financed Social Security systems. In the United States, there were 16 workers per beneficiary in 1950; today there are about 3.3. It is expected that there will be only two in just 35 years. Therein lies an interesting paradox: as countries become wealthier their Social Security systems become more poorer. The oddity is driven by the causal relationship between increasing wealth and increasing life expectancy as well as decreasing birth rates, all wrapped around pay-as-you-go financing.

Birth rates have fallen to such low levels in Europe—France-1.9, Germany-1.4, Italy-1.3, Spain-1.3—that “there is now no longer a single country in Europe where people are having enough children to replace themselves when they die.”

The Global Political Response: Raise Taxes

The political responses to the changing demographics that squeeze Social Security's finances are frequently the same across the world. Governments and politicians tend to see the problem in the narrowest of lights: merely a solvency issue—too many benefits paid, too few taxes received. This near-sighted analysis is further compounded by the focus on just today's solvency and not tomorrow's.

But from this myopic perspective the options are clear: raise taxes, cut benefits. Of the two, governments tend toward raising taxes first. This makes sense for at least a couple of reasons. There are more workers to tax than there are retirees from whom to cut benefits. Therefore, if the choice were only one or the other, raising taxes inflicts a lesser per capita burden. The second reason is that workers are younger than retirees; therefore, they have more time to adjust to a tax increase than retirees have to adjust to a benefit cut.

The short-sighted strategy of raising taxes has been employed worldwide. In the United States, for example, in 1950 when there were 16 workers per beneficiary, the maximum Social Security tax any American worker paid was \$90 a year. At that time the tax rate was 3 percent on only \$3,000 of wage income. As the glacial force of demographics slowly and unrelentingly

squeezed the system, the \$90 tax rose and squeezed the worker. Now, the tax, just for the retirement portion of Social Security, is 10.6 percent of \$90,000, or \$9,540. After adjusting for inflation over the last 55 years, that tax has increased almost 2,000 percent. In all likelihood, the reason that we stood for this is that the tax rose slowly; the increase was never really noticeable in any one year, but over time it has become more of a burden than the income tax for about three quarters of American workers.

Our friends in Europe, however, would consider us lucky. The payroll tax in France is about 50 percent and in Germany, Italy and Spain it ranges roughly between 38 and 42 percent. It is true that these countries' systems provide more services than ours, but this is not a plus, for Europeans are dependent on more of their needs from government programs that are not sustainable.

As many European nations have raised their payroll taxes to prohibitive levels, they have choked individual economic freedom and incentive. Economic growth is stagnant, and unemployment rates hover around 10 percent, even 12 percent in Germany. Civil unrest is now more common in Germany and France as governments tell their people that benefits are no longer affordable and will have to be cut, while at the same time they extol the virtues of the welfare state. We are traveling the same path.

Then, Cut Benefits

At some point, the strategy of raising taxes approaches a political wall. People sense that maybe, just maybe, they could achieve more with their hard-earned wages than they get from Social Security. Politicians sense this and move to the lesser desirable option of cutting benefits. Such blunt language, however, is not commonly uttered. Code is employed: progressive price indexing, longevity indexing, adding a third bend point, reducing bend point factors, increasing the NRA, decreasing the PIA, and it goes on and on. It's all code for cutting benefits.

Fundamental Reform: Retarded by the Claim of Insurance

Eventually, after cutting benefits hits its political wall, the thinking shifts to fundamental reform, saving and investing in wealth-producing assets for all workers. This idea of market-based financing for retirement income is not new, in fact it is old and well-established in the private sector, but it is viewed with some disdain from advocates of the status quo. They object to the notion that Social Security should be an investment structure and defend their objection by claiming that it is insurance. This claim had some merit decades ago, but not now. In fact, Social Security's finances are in trouble largely because



they are inappropriately based on the insurance model.

Insurance works well when many people are subject to an event that has little chance of happening to any single individual. A good example is homeowners' fire insurance. Many people buy fire insurance to protect their homes and yet few homes burn. Because the number of homes insured is many times the number of homes that burn, the annual insurance premium is very low relative to the replacement cost of one's house. Insurance companies are simply the medium through which individual uncertainty of loss is transferred to, and financed by, the group.

The insurance model does not work well when the group is subject to an event that the entire group experiences. For example, if it were certain that everybody's house would burn down, say, when the owner reached age 65, then insurance companies would have to charge annual premiums the future value of which would be the cost of rebuilding all the houses. This premium would be a large multiple of the premium charged for the uncertain case. Central to the insurance model is that the ratio of the annual premium to the dollar value of what it protects is negatively correlated to the uncertainty of individual loss.

Social Security is frequently heralded as insurance, more precisely social insurance. The 'social' part of the term merely means that the government plays the role of the insurance company. Other than that, it remains the insurance model. When Social Security was enacted in 1935, life expectancy was 61 but benefits weren't payable until age 65. Now benefits are payable at age 62 and life expectancy is 78. The element of uncertainty has flipped upside down. Because of this, the retirement component of Social Security isn't insurance; once born, reaching age 62 and needing retirement income is almost certain. As a result, there is very little risk, or uncertainty, to transfer to the group, resulting in the fact that annual premiums must be enough to accumulate to a sum, including interest, that will finance retirement income.

Under these conditions, social insurance cannot provide such income at a lower cost than saving and investing for retirement. Unfortunately, however, it can and does provide it at a higher cost because it is financed through the payroll tax and is subject to unyielding demographic forces. In a perverse way, Social Security's finances and its adherence to the insurance model are caught in a kind of time warp; in the age of the iPod Social Security is a 78 RPM, wind-up phonograph. Unless protected by the power of the state, it can neither compete nor survive.

The State Monopoly Faces Competition

Being protected by the power of the state really means that, for 10.6 percent of their wage income, American workers are not free to choose among alternatives for their retirement. Bad as that is, the 10.6 percent doesn't buy much relative to reasonable and available alternatives. This is why Social Security is mandatory; few would participate if they had the freedom not to. Competition, as always, is a threat to the status quo. For workers, however, competition is their hope.

Competition would allow all workers to invest part of their payroll tax in capital markets around the world, in professionally managed portfolios that are highly diversified across asset classes, national borders and time. Such an opportunity would allow one to accumulate enough wealth to replace the pay-as-you-go benefit entirely.

For an average wage worker retiring this year at age 65, Social Security's scheduled benefits are projected to replace about 42 percent of his last year's wage. But for workers retiring in the future, full benefits won't be paid until age 67. For those future retirees, should they choose to retire at age 65, benefits will replace only 36 percent of their last wage. The worker's cost for these scheduled benefits, which are in excess of what is affordable based on present law, is the 10.6 percent payroll tax.

The Market-Based Alternative

The market-based alternative is significantly more attractive. Over the last 79 years, a conservative portfolio of 60/40 percent stocks and bonds, respectively, earned a real return of just a little over 7 percent. Investing just half of the retirement payroll tax, 5.3 percent, each year for 45 years would provide a retirement benefit equal to 97 percent of one's last year's wage. This assumes that there is no interruption in saving each year, that the market return is as stated and falls by 2 percent during the distribution phase, and that life expectancy upon retirement is 20 years. Each of these assumptions can be changed. Work may be interrupted. Markets may do worse or better. Life expectancy may be more or less than 20 years once retired.

To take a conservative path, if the market return were only 5.5 percent and if life expectancy were 30 years at the onset of retirement—about 10 years more than assumed by Social Security—then under these conditions the replacement rate would be 39 percent, higher than Social Security's scheduled benefits at age 65 and significantly higher than payable benefits.

Americans Understand the Tradeoffs

Our citizens sense these tradeoffs, risks, uncertainties, and the fundamental differences in providing retirement income from a tax system versus a sav-



ing and investment system. This is why, but only part of why, they want the option, the freedom to choose.

If they could acquire this freedom, they also would have personal property rights over their accumulated wealth. They have no such rights to Social Security benefits. They also could bequeath some or all of their retirement assets. They cannot under Social Security. They would benefit from the direct relationship between effort, their saving, and reward, their accumulated wealth. They would have the dignity that comes with being personally responsible for their future. They would no longer be tethered to the government. They would no longer be subject to politicians' preferences over when they can retire, how much they can get, how their spouses are treated, how much they're going to pay, and all of the rules and regulations that have evolved to the point of being incomprehensible. They would be free.

But that freedom would come with some structure because many people want the option to save for retirement, but are not knowledgeable of markets. The structure is designed to allow them the benefits of markets without causing each and everyone to be an expert. Here is how it may work.

The Objective: An Individual Account, Market-Based Social Security Option

The objective is to develop an investment and administrative plan that:

1. Creates individual accounts with assets owned by the account holder;
2. Ensures reasonable costs for all participants, low- as well as high-income workers;
3. Minimizes employers' administrative burden;
4. Provides the opportunity for workers of all incomes to invest in capital markets;
5. Ensures that inexperienced investors will not suffer poor returns relative to experienced investors;
6. Provides investment choice;
7. Offers a solution for workers who make no investment choice;
8. Automatically adapts to changing technology and services offered by the financial services industry.

These objectives are considered important because they have been central in the debate on Social Security reform. They are also integral to the most popular defined contribution system in the United States, the 401(k) plan.¹ Indeed, the 401(k) plan structure is often referenced as a potential model for an individual retirement account plan for Social Security. It should be noted that even though the 401(k) plan may be a useful model, it is unlikely that it would be applied precisely.

¹ Profit Sharing/401(k) Council of America. "Helping Americans to Help Themselves: The Role of Profit-Sharing/401(k) Plans in the Retirement-Income Security Framework." <http://www.pzca.org/role.html>.

The Model: The 401(K) Plan

Since the late 1970s, defined contribution systems have increased in popularity among American companies and workers. And just since 1985, those that have sponsored as well as those that have participated in 401(k) plans have increased several fold.

Under 401(k) programs, a plan sponsor, usually a company or union, oversees administration of a savings and investment program for its employees. Under such plans:

1. Employees opting to participate in the program designate the amount they wish deducted from their pay;
2. Employees select investment options prescribed by the plan sponsor;
3. The plan sponsor deducts the specified funds from the employee's pay and in many cases invests the funds as of that day in the designated investment vehicles;
4. Deductions are made on a pre-tax basis;
5. Investment earnings grow on a tax-deferred basis;
6. Benefits are subject to tax when taken out;
7. In many plans, the employer provides some level of matching contribution to the employee's account;
8. Account holders normally can call an 800 number voice response unit or individual account representative and change their portfolio holdings and receive that day's closing price for each asset traded.

In the early years of 401(k) plans, investment options were often limited to a stable value fund, a diversified fund and company stock. In recent years, however, there has been a significant increase in investment choice. Many plans now include a large number of investment options as well as self-directed brokerage accounts. These accounts provide access to a large universe of institutional and mutual funds as well as individual securities. With all of the choice available, individuals can now create portfolios that are appropriate for their age, their risk tolerance, and their wealth objectives.

The Challenge: The Government's Record-Keeping and Accounting System

The major challenge in creating a 401(k) model of individual accounts linked to Social Security is the timely posting of individuals' savings contributions. This is not possible given the present Social Security record-keeping system.² Although the Treasury Department has built a comprehensive system for the collection of FICA taxes from employers, there is no detailed record of individual taxes paid at the time they are collected and sent to

² See, for example, Kelly A. Olsen and Dallas L. Salisbury, "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs." *EBRI Special Report and Issue Brief* #203.



Treasury. This information is not communicated to the government until the following year.

Companies remit FICA taxes in lump sums throughout the calendar year, but do not forward to the government at the same time the names of the individual employees who paid those taxes or the amount each paid. That information isn't provided to the government until the next calendar year when the employer sends W-2 forms to both the government and the employee. Treasury knows throughout the year, for instance, that a company has paid a sum of FICA taxes for its employees, but the Social Security Administration will not update its records until late June of the next year, and possibly a few months later, with the names of the individual workers who paid those taxes and how much each worker paid. The government never knows when during the year the individual paid the taxes. This recordkeeping process, although workable in Social Security's defined benefit structure, is unworkable in a daily environment defined contribution structure. But it is all that currently exists for identifying individual payroll taxes.

The Solution: A Three-Level Approach

A solution is to structure investment options, not all of which require timely and detailed contribution data. This approach involves three investment levels.

At the first level, workers' savings are deducted from payroll and invested in a collective money market fund. Workers own the assets of the fund although the accounting at the individual level is not completed until the following year. This reconciliation is accomplished with the filing of the W-2 form. When the individual's assets are accounted for, units in the money market fund, which include earned interest, are then posted to each worker's account. The fund is dollar priced which means each unit is valued at one dollar.

The units are then invested in one of three balanced funds selected by the worker. Individuals who do not or choose not to make a selection have their assets invested in a default option.

The account holder has the option--after a startup of about three years, a period required to successfully build up assets to achieve economies of scale--to transfer some or all of his balance to an appropriate retail retirement account.

Level One Investment: A Pooled Money Market Account

This pooled account would be a conservative fund similar to a large institutional money market fund. The funds would be held in this pool earning interest for all participants. Given that the timing of an individual's contribution is not known, all participants are assumed to invest on June 30th. Because of this assumption, high-income workers effectively subsidize low-income workers because high-income workers contribute a disproportionate amount of their income during the early part of the year.

Each worker would know during the year how much is invested because it is the same as the year-to-date reduction in the FICA tax that goes to savings, often referred to as the carve-out. The carve-out may be itemized as a separate line item on the pay stub. Interest would always accrue, so the account balance would be in excess of the contribution. All workers, regardless of income, would receive an identical rate of return. Funds would remain in the money market account until the reconciliation of how much each worker contributed, about August of the following year.

Level Two Investment: Balanced Funds

When the individual account balance is determined, it is converted to units in one of three balanced funds that the worker chooses. Balanced funds are diversified portfolios that are generally invested in stocks, bonds and cash. The combined assets underlying very successful private employer-sponsored defined benefit plans are essentially balanced funds. One of the Level Two balanced funds may have an allocation that closely approximates these plans. This allows all workers, if they wish, to maintain an asset allocation similar to that provided to the employees of many sophisticated corporations in the world. There would be another fund on each side of this fund: one for younger workers that would be weighted more toward equities, while the other would be weighted more toward bonds for those closer to retirement.

Although workers could choose their balanced fund, some may not. In this case, they would default to the middle fund. In other words, a worker—perhaps low income and financially unsophisticated—would be invested in a well-diversified, balanced portfolio suited for retirement savings. The portfolios would be managed by professional asset managers chosen through an open and competitive bidding process. Index fund investment management fees most likely would be less than two basis points (bps): two one-hundredths of one percentage point. The balanced funds would be valued daily and prices would be published in the popular press. Workers only need multiply their units by the daily price to monitor their account balance.



Level Three Investment: Rollover Option

After a period of perhaps three years, a period required to successfully build up the assets in the Level Two account system to realize economies of scale, investors seeking more investment choice would have the option of rolling their investment funds out of the Level Two asset allocation funds and into any qualified retirement investment account.

Those choosing Level Three would transfer assets to a qualified account with a financial services company meeting reasonable and specified standards.³ While investors would have a wider range of choice within Level Three, there still would be reasonable investment guidelines. In Level Three, investment managers would act as the fiduciary for their product offerings and be subject to Department of Labor oversight. This is consistent with many employer-sponsored plans, both defined contribution and defined benefit.⁴

Level Three might well suit those workers who have a high degree of confidence in a particular money manager, a particular firm or a particular style of investing. It will also serve investors seeking a type of investment unavailable in the Level Two asset allocation funds. An investor, for example, may wish a greater concentration of equity investments than is available in the asset allocation funds. Should a worker find a particular Level Three provider or product unsatisfactory, the worker could transfer to another provider or move back to Level Two. This assures competition across Level Three as well as competition between Levels Two and Three. Competition will ensure the lowest cost and best service for the entire system.

Record-keeping and Administration

The administration of an individual account system will require the development of a large-scale, customized record-keeping system with the capability to produce a highly efficient service solution. The efficiency of the service application will be dependent upon the design and execution of the system. There is no existing application that meets all the requirements.

The requirements to support a national individual account system will be complex, large-scale and capital intensive. As noted above, this is a challenge of unprecedented scope.

³ This process should be fully automated and driven by a third party, such as the National Securities Clearing Corp. At the individual account holder's instructions the Level Three provider should be able to initiate the transfer and cause the money to be moved from Level Two to Level Three without having to provide any paperwork.

⁴ Department of Labor Pension and Welfare Benefits Administration. "Study of 401(k) Plan Fees and Expenses." April 13, 1998.

Nonetheless, the application itself is relatively straightforward. Development time can be minimized to allow focus on sizing and scaling the network and building the necessary interfaces to the Social Security Administration (SSA). Unlike mutual fund or 401(k) record-keeping systems, there will not be many unique product features or functions, thus significantly reducing complexity and cost. It is reasonable to assume a system could be developed in 12-18 months to support these requirements.

The greatest challenge in building a record-keeping system to support the requirements of an individual account system is not the complexity of the application, but the need to support the high volume of participant inquiries, transactions, transfers and report generation. To keep costs low, it is critical that most participants utilize voice and Internet technology to obtain information and transact business. The greater the percentage of calls that requires a customer service agent, the higher the administrative cost.

The volume of calls will be driven by the frequency of transactions and statements, as well as average account size and market volatility. Assuming 140 million accounts and the plan described, participant call volumes are projected to range from 175 million to 350 million annually. In addition, the system will issue 140 million statements, process fund transfers and distributions. This approach assumes the funds are priced daily and accounts updated nightly.

Whether the record keeping is done by a government entity such as the Social Security Administration or outsourced to the private sector, this task will require the formation of a large service organization to support these requirements. The service firm would need call centers in multiple locations around the country and would need to hire between three and seven thousand employees. For the purpose of this analysis, it is assumed that the Social Security individual account system will incur volumes between 0.5 and 1.0 calls per participant per annum.

Another important factor in projecting costs is determining what percentage of the participant's call volume will be processed by voice response and Internet technology versus requiring the services of a call center representative. The cost to handle calls using the technology is a fraction of the cost to process through a representative. Therefore, to achieve an efficient solution, it is critical that high levels of automation are achieved. The analysis assumes 85 percent of the call volume will be handled through voice and Internet technology, comparable to the levels currently achieved in many large defined contribution plans. Estimated first year expenditures will range from \$473 to \$922 million.



Cost Model

Based on the plan design defined above, a cost model has been developed to project the administration costs under a range of assumptions. The unit cost factors are based on experience in the 401(k) business and have been adjusted in some cases to account for the scale of the individual account option. The requirements of a national system of individual accounts are unique and, therefore, extrapolations from 401(k) experience pose some risks. Unlike the 401(k) structure, we assume that in a timely fashion the Social Security Administration will provide the individual account recordkeeper an accurate, automated transmission of earnings histories that will be used to calculate annual contribution data. These and any other expenses associated with reconciling W2 records are to be borne by Social Security and are not included in this cost model. It is also assumed that Social Security, at its cost, will maintain accurate and up to date employee address files, as will be necessary anyway with the annual mailing of Social Security statements starting in 2000. We envision that one's investment account statement would be included in this mailing.

Another cost not included in this model is the expense associated with communicating this program to employees. The assumption is that the government would bear these expenses. Therefore, they expressly are not included in the asset based fees reported below. There is precedent for this in that the government pays directly some of the communication expense of the Federal Thrift Plan.

Cost Summary

Based on the design criteria outlined and our unit cost assumptions, it is projected that the first year's administrative expenses to support an individual account system will range from \$473 to \$922 million. Assuming 140 million accounts, this translates to a cost per account range of \$3.38 to \$6.58 in the first year. Although costs would be expected to increase annually, driven primarily by employee compensation and benefits, assets would increase more rapidly. Costs as a percent of assets, therefore, would fall. We project that steady-state asset based costs would range from 19 to 35 basis points.

These costs are competitive with other investment products. For example, the Federal Thrift Plan, which is often used as an example of an efficient retirement plan, had an expense ratio of 65 bps in its second year. Another benchmark is a portfolio of individual mutual funds representing different asset classes and weighted to approximate a Level Two balanced fund. Such a portfolio is presently available for a total cost of about 40 basis points.

Final Comments:

Although many approaches to the administrative challenges inherent in an individual account system linked to Social Security may be expensive, not all need to be. Under reasonable assumptions, a well thought out plan that meets our nation's retirement needs is affordable.

Although our nation has wasted time in the reform of Social Security, during this period we have learned much in how to administer a more modern system and why reform is so important. There is now little excuse to wait longer.



Encouraging Financial Security: First Do No Harm

Jason Furman

America faces major budget deficits and perilously low national savings. These problems are expected to grow significantly over the coming decades. At the same time, Americans are struggling to plan for their retirements. Reforming Social Security and our private pension system, if done correctly, can play a meaningful role in addressing these challenges.

It is better to act sooner rather than later. But even more important than acting sooner is to obey the Hippocratic Oath: first, do no harm. If done in the wrong way, Social Security and pension reform could worsen our long-run fiscal outlook, depress national savings, and make retirement even less secure.

In my paper I will first discuss the fundamental goals of Social Security and pension reforms. Second, I will explain why President Bush's Social Security plan fails to satisfy these goals. Third, I will evaluate the idea of replacing the President's "carveout" accounts with what proponents call "add-on accounts." Finally, I sketch a better approach to restoring Social Security solvency and encouraging moderate income families to save more.

The views expressed are those of the author and do not necessarily reflect official positions of Networks Financial Institute. Please address questions regarding contents to Jason Furman at jason.furman@nyu.edu. Any errors or omissions are the responsibility of the author.

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I. Goals of Social Security and Pension Reform

Social Security and pension reforms should be guided by four principal goals:

1. Restore Social Security Solvency. If no changes are made, the Social Security Trust Fund is projected to become exhausted in 2041 and tax revenues will be sufficient to only pay 74 percent of scheduled benefits in that year.¹ The preeminent goal of Social Security reform is to ensure that Social Security is sustainably solvent while using only dedicated revenue and avoiding abrupt and dramatic tax increases or benefit reductions in the future.

2. Address America's Fiscal Challenge – Both in the Short Run and Long Run. In fiscal year 2004, the federal government ran a unified deficit of \$412 billion, or 3.6 percent of Gross Domestic Product (GDP). Over the coming decades, the combination of phased-in tax cuts, rising health costs, and demographic changes will inexorably lead to significantly larger deficits and debt. Deficits of this magnitude reduce economic growth, increase the likelihood of an economic crisis, and will inevitably require higher taxes or lower government spending in the future. Although Social Security is not the principal source of these deficits, well-designed Social Security reform can and should play a modest role in reducing deficits both in the short run and in the long run.

3. Strengthen Retirement Security.² Financial planners recommend having enough income in retirement to replace about 70 percent of pre-retirement income. Social Security plays a critical role in guaranteeing a comfortable retirement for most Americans: more than two-thirds of retirees rely on Social Security for more than half of their retirement income.³ But the current Social Security system has some deficiencies, including high poverty rates for widows, high poverty rates for older beneficiaries, and the lack of an effective minimum benefit to ensure that retirees do not fall below the poverty line. To supplement Social Security, workers rely on defined contribution plans like 401(k)s and personal savings through IRAs and other vehicles. But about half of Americans work at companies that do not offer

¹ Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds*, ("2005 Trustees Report"). All estimates in this paper are based on the Social Security Trustees' assumptions.

² Strengthening disability security is also a critical priority but one that is beyond the scope of this paper.

³ Thomas Hungerford et al., "Trends in the Economic Status of the Elderly, 1976-2000" *Social Security Bulletin* 64:3, January 2003.

pensions and the current system provides little or no tax incentive to help moderate-income families save. Reform can strengthen retirement security by ensuring that future Social Security benefits are adequate, sustainable, and supplemented by additional savings.

4. Increase National Savings. Increased national savings would lead to more investment, augmenting the capital stock and thus future economic output. Or, higher national savings would reduce the need for foreign borrowing, which means that Americans would be able to consume more of our future economic output. Increasing national savings is the only way to expand the economic pie. This is the only way to ameliorate the potentially painful tradeoff between future consumption by the young and future consumption by the old. In the last three years, net national savings has averaged 1.6 percent of GDP – the lowest level in seventy years. At the same time, investment was financed by an average 4.8 percent of GDP in capital inflows from abroad, the highest level on record. Borrowing at this level is unsustainable and eventually this debt will need to be repaid. Social Security and pension reform can help increase private savings and reduce government dissaving (i.e., by reducing budget deficits).

Reform should advance these four goals. Any reform that impedes progress on any of these goals must be rejected. For example, it would be easy to make Social Security solvent by transferring trillions of dollars to the Trust Fund, but that would be a fiscal disaster and it would hinder efforts to increase national savings. To give another example, it would be easy to provide new tax incentives for savings. But if these tax incentives are not fully paid for and well-designed, they could worsen the long-run fiscal outlook and reduce national savings.

II. The President's Social Security Reform Proposal

President Bush's Social Security reform proposal is largely moribund. Nevertheless, it is likely that private accounts proposals will be revived again in the future. That is why it is important to analyze the plan closely and understand it as well as possible. While private accounts plans vary greatly, many of them will have elements – and associated problems – in common with the plan the President advanced.



The President's Social Security plan has two parts: voluntary private accounts and sliding-scale benefit reductions modeled on investment executive Robert Pozen's "progressive price indexing" plan.⁴ Although the full details of the plan have never been worked out, sufficient detail has been made available to assess its ability to meet the four principal goals of Social Security and pension reform.⁵

A. The President's Proposal and Social Security Solvency

The President has proposed sliding-scale reductions in Social Security benefits for retirees and survivors. Reductions would start in 2012 and grow over time. The White House states that its "reform would solve 70 percent of the funding problems facing Social Security," although a more comprehensive accounting would show that the plan closes about 60 percent of the 75-year deficit.⁶ Any measure that does not eliminate the entire 75-year shortfall in Social Security will result in the Trust Fund becoming exhausted at some point in the next 75 years. The President's sliding-scale benefit reduction plan would push back the exhaustion of the Social Security Trust Fund by 6 years, to 2047. After that date, a roughly 15 percent across-the-board benefit cut – on top of the benefit cuts that the President has proposed – would be required to achieve solvency.

The President also proposes to allow workers to divert 4 percentage points of their payroll taxes (up to a maximum amount) into individual accounts. The President's proposal would require workers, in effect, to repay the "loans" these contributions represent through a reduction in their traditional defined Social Security benefit.

The accounts would substantially worsen Social Security's projected shortfall over the next 75 years because, under the President's proposal, reductions in Social Security benefits to repay the Trust Fund for the funds diverted into accounts would be made with a lag. Some of the funds diverted from Social Security to accounts over the next 75 years would not be repaid until after the end of the 75-year period.

The accounts would also worsen projected solvency over the infinite

⁴ See White House, "Strengthening Social Security," February 2005 and Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005 and White House, "Fact Sheet: Strengthening Social Security for Those in Need," April 28, 2005.

⁵ All estimates are based on the assumptions of the Social Security Trustees, unless indicated otherwise. Additional details underlying this analysis are available in Jason Furman, "The Impact of President Bush's Proposal on Social Security Solvency and the Budget," Center on Budget and Policy Priorities May 10, 2005 and Jason Furman, "An Analysis of Using 'Progressive Price Indexing' To Set Social Security Benefits," Center on Budget and Policy Priorities, May 2, 2005.

⁶ The Pozen plan closes 70 percent of the 75-year Social Security deficit. The White House modified the Pozen plan, dropping his proposal to reduce disability benefits, and thus closes less of the 75-year deficit.

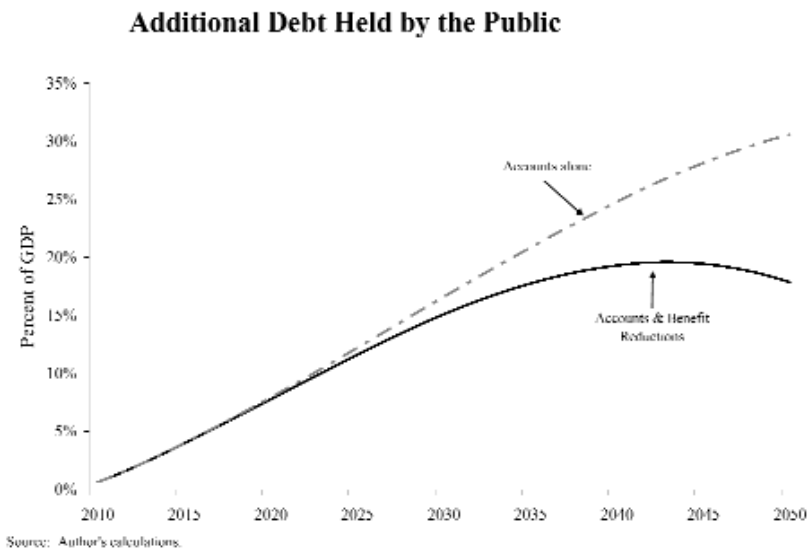
horizon, but by a smaller percentage. This is because in a significant percentage of cases the benefit offset required to make the accounts actuarially neutral will not be collected. For example, if an unmarried worker dies prior to retirement, his or her entire account goes to his or her estate and the benefit offset is not collected. Or take the case of the higher earner. In many cases, his or her entire Social Security benefit would be less than the benefit offset associated with the account. In those cases, the higher earners' entire traditional benefit would be wiped out but the Trust Fund would not collect the remainder of the benefit offset and solvency would be worsened. This case would apply to anyone with steady earnings at or above the payroll tax cap (now \$90,000 a year) who retires after 2060. There are other such examples.

B. The Fiscal Impact of the President's Proposal

The President's Social Security proposal would result in a large increase in the debt held by the public, in the near term and over the longer term (i.e., the next 60 years). The President's accounts would add \$1.5 trillion to the debt over the first ten years that the plan is in effect (from 2009 to 2018). The accounts would cause the debt to increase by another \$3.8 trillion in the decade after that, for a total of \$5.3 trillion over the first twenty years.

The sliding-scale benefit reductions that the President is proposing would reduce the debt by relatively modest amounts in coming decades. Over the first twenty years, those benefit reductions would reduce the debt by \$400 billion. The combined effect of the accounts and the sliding-scale benefit reductions the White House is proposing would be to add \$4.9 trillion to the debt over the first twenty years.

Figure 1





The debt would continue to rise after twenty years, both in dollar terms and as a share of GDP, as shown in Figure 1. The accounts, by themselves, would lead to *permanently* elevated debt. Although the sliding-scale benefit reductions would eventually start to bring that debt down, the debt would remain elevated through 2067. This would lead to higher interest payments on the debt, increasing the burden for future taxpayers.

Some have argued that the additional debt associated with the accounts would not be a source of concern for financial markets or the economy more broadly. They argue that, over an infinite horizon, this debt diminishes or disappears, and that as a result, even the initially high levels of debt should be considered neutral from an overall fiscal position. The accounts causing no fiscal harm is the best case scenario. No one has argued that the debt associated with the accounts has any fiscal benefits.

There is a significant probability that the debt associated with the accounts would harm the economy.⁷ The borrowing to pay for the accounts would take the form of “explicit debt,” that is, government bonds. These bonds cannot be defaulted on and must be rolled over or serviced on an annual basis. This explicit debt would replace “implicit debt” in the form of reduced future Social Security obligations. Implicit debt, however, is very different from explicit debt. It does not need to be rolled over or serviced on an annual basis. The total amount of implicit debt is based on projections and is not legally binding, unlike the tangible debt issued in the form of Treasury bonds.

Financial markets, both in the United States and abroad, are likely to be more troubled by the explicit debt than they currently are by the implicit obligations of the U.S. government. Federal Reserve Chairman Alan Greenspan testified that if financial markets did not distinguish between implicit and explicit debt, then the borrowing associated with accounts would have no impact on the market. But he went on to say, “But we don’t know that. And if we were to go forward in a large way and we were wrong, it would be creating more difficulties than I would imagine.”⁸

The record is replete with nations undergoing fiscal crises because of explicit debt. No nation has undergone a fiscal crisis because of implicit debt.

⁷ For an extended discussion of these issues see Jason Furman, William G. Gale and Peter R. Orszag, “Should the Budget Rules Be Changed To Exclude the Cost of Individual Accounts,” *Tax Notes* January 24, 2005.

⁸ Alan Greenspan Testimony, February 16, 2005.

Furthermore, rational financial markets would understand that the eventual repayment of the debt associated with the President's accounts would be decades in the future and would depend on large and potentially politically unsustainable benefit reductions. To the degree that financial markets partially discounted these benefit reductions or factored in the possibility of a government bailout in the event of a major stock market crash, this added debt would have a significant impact.

As Harvard economist Martin Feldstein explained in a paper he wrote in 2001, he had advised against President Reagan establishing individual accounts in part because "the overall budget was in substantial deficit, starting to fund investment-based accounts would have required a tax increase or an even larger overall budget deficit."⁹

In summary, the accounts portion of the President's plan would result in *permanently* higher debt than the same plan without accounts. Even when combined with sliding-scale benefit reductions, the debt would be elevated for more than sixty years. It is important to remember that even from the vantage point of 2067, when the debt would be the same as under current law, the proposal would be judged a failure. The goal of Social Security reform is not to leave the debt the same as under current law, it is to significantly reduce the debt in order to help relieve future fiscal pressures. The debt associated with the President's accounts proposal would have no upside benefits and substantial downside risks.

C. The Impact of the President's Proposal on Retirement Security

The President has not proposed any revenue increases for Social Security but instead is proposing to drain revenue from Social Security into individual accounts. Together, this necessitates very large reductions in traditional defined Social Security benefits. The President's plan includes two sets of benefit reductions. The first benefit reduction is a sliding-scale benefit reduction that would apply to all workers making over \$20,000 per year (and some beneficiaries making even less than \$20,000 per year). The second benefit reduction is the benefit offset that would apply to workers who opt for private accounts. Together these proposals would greatly diminish Social Security – the core tier of retirement security. The large majority of Americans would rely on investments that are subject to market risk for the large majority of their retirement income. Accounts will not necessarily make up for benefit offsets. As a result, workers would be left with substantially lower retirement income than they enjoy under the current-law formula.

⁹ Martin Feldstein, "Comments on Fiscal Policy and Social Security Policy During the 1990s," in Jeffrey A. Frankel and Peter R. Orszag (eds.) *American Economic Policy in the 1990s*, Cambridge, MA, MIT Press, 2002.



The First Benefit Reduction: Sliding Scale Benefit Reductions

The President is proposing to reduce benefits relative to the current-law benefit formula. This proposal would apply to the large majority of beneficiaries, whether or not they opt for accounts. Under the President's proposal, Social Security would replace a smaller and smaller amount of recipients' pre-retirement income. These replacement rates are the most meaningful way to compare Social Security benefits over time.

Social Security replacement rates would be reduced for all beneficiaries who make over \$20,000 annually. In addition, as explained below, replacement rates would be reduced for some beneficiaries who make less than \$20,000 annually.

The replacement rates would be reduced more for higher-income beneficiaries. The Social Security actuaries have estimated that the average worker (someone who currently earns \$37,000) would see his or her replacement rate reduced by 16 percent in 2045 and 25 percent in 2075. A so-called "high earner," someone with income 60 percent above the average (or current earnings of about \$59,000) would see his or her replacement rate reduced by 28 percent in 2045 and 42 percent in 2075.

While the President's plan does protect low-income retirees who earn benefits based on their own work histories, it does not necessarily protect people who earn so-called "auxiliary" benefits based on another person's work history. For example, widows, surviving children and ex-spouses all get benefits based on another worker's earnings. If that worker makes over \$20,000 annually (i.e., is in the top 70 percent), the widows, surviving children or ex-spouses would all get benefit cuts – even if the beneficiaries themselves have a much lower income, as they well may in the aftermath of a deceased worker's death or a divorce.

The Second Benefit Reduction: The Benefit Offset for Private Accounts

In addition to the first benefit reduction, workers who opt for the President's proposed private accounts would be subject to a second reduction in their traditional defined Social Security benefit.

Under the President's proposal, workers could contribute up to 4 percent of taxable wages to private accounts. These contributions would be capped at \$1,000 in 2009, with the cap increasing thereafter by \$100 per year, plus wage inflation. By 2041, all workers would be able to contribute a full 4 percent of taxable payroll to their accounts. Workers who elect private

accounts would have their traditional Social Security benefit reduced by their contributions to the accounts, plus an interest charge set at 3 percent above the inflation rate.

The combination of the sliding-scale benefit reductions and the benefit offset associated with private accounts would radically transform retirement, leaving the average worker with a fraction of the traditional Social Security benefit he or she is entitled to today. Consider an average worker retiring in 2055, the first worker who would be eligible to participate fully in the President's proposed accounts. The sliding-scale benefit reduction would reduce this worker's scheduled benefit by 21 percent. The benefit offset would reduce the scheduled traditional Social Security benefit by 45 percent. Together, these two benefit reductions would reduce the traditional defined benefit by 66 percent. This worker would have a guaranteed benefit of only \$7,500 annually, or a replacement rate of about 12 percent of pre-retirement income. The majority of the workers' retirement income would come from the individual account, pensions, and other savings - all of which is subject to market risk.

These double reductions in benefits grow dramatically for higher income workers and workers retiring later. For example, a worker making the equivalent of \$59,000 in today's wage-adjusted dollars and retiring in 2075 would see a 97 percent reduction in his or her traditional defined Social Security benefit. Virtually all of this worker's retirement income would come from the individual account and other savings.

The combination of sliding-scale benefit reductions and carveout accounts raise very serious concerns about the unraveling of Social Security. The benefit offset for the accounts is designed in such a manner that it would lead participants to devalue their traditional Social Security benefits (and all the associated disability insurance, life insurance, and other advantages) and overvalue their private accounts. Many Americans would appear to get little or nothing from their traditional Social Security contributions, while lower-income families would still get relatively more substantial benefits. This could lead to significant political pressure to shift more of Social Security into private accounts and reduce defined benefits for lower-income workers.

Would Higher Returns on Accounts Make Up for These Benefit Reductions?

Would the accounts the President is proposing help make up for these benefit reductions? The way the accounts are structured, a participant would need to get a rate of return (after subtracting administrative costs) that is more than 3 percent above the inflation rate to make up for the second benefit reduction, the benefit offset. A rate of return of well above 3



percent would generally be needed to make up for both sets of benefit reductions.

The President has proposed to set up “lifecycle” accounts as the default option for investors. These accounts would switch portfolio allocations towards bonds as a worker nears retirement. The goal is to capture potentially higher stock market returns while reducing the risks associated with stock market investment. Noted financial economist Robert Shiller, author of *Irrational Exuberance*, however, showed that “lifecycle” accounts do not provide a free lunch and are still subject to considerable risks.

Shiller conducted a simulation using historic returns from 1871 to 2004 to answer the question of whether or not workers would come out ahead of the 3 percent hurdle required to make up for the second benefit reduction.¹⁰ Using actual historical returns, Shiller found that workers opting for a “lifecycle account” modeled on the President’s proposal would end up losing money 32 percent of the time. That is, 32 percent of the time workers would not even make enough to overcome the benefit offset. They would be worse off as a result of opting for the accounts.

Shiller, however, believes that these historical returns are likely to overstate the returns to accounts because future stock market returns are not likely to be as high as past returns. As a result, he conducted the simulation using what he considers more “realistic” returns that are more reflective of future stock market performance. Shiller finds that workers would lose money on the accounts 71 percent of the time. Even the more realistic returns assumed for the second part of Shiller’s study are higher than the returns projected by a wide range of financial economists surveyed by the *Wall Street Journal* in February 2005.¹¹

Moreover, even these lower rates of return do not take into account the additional risks associated with equity investment. Virtually all economists agree that any assessment of the likely outcome of this margin loan should take into account the additional risks associated with investing in equities. As Gary Becker, a Nobel Laureate in economics and supporter of individual accounts explains: “There are no freebies from such investments since the higher return on stocks is related to their greater risk and other trade-offs

¹⁰ Robert Shiller, “The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation,” March 2005.

¹¹ Mark Whitehouse, “Social Security Reform Plan Leans on Bullish Market,” *Wall Street Journal*, February 28, 2005.

¹² Gary Becker, “A Political Case for Social Security Reform,” *Wall Street Journal*, February 15, 2005.

¹³ Congressional Budget Office, “Long-term Analysis of Plan 2 of the President’s Commission to Strengthen Social Security,” July 21, 2004. CBO assumes a risk-adjusted rate of return on investment of 3.3 percent, which is CBO’s projected return on Treasury bonds, minus 0.3 percent for administrative and management fees.

between stocks and different assets.”

The Congressional Budget Office (CBO) uses what is known as “risk adjustment” in estimating the featured returns on private accounts established under Social Security plans. This means that CBO adjusts stock returns to reflect the higher risk that stock investments carry. Under CBO’s analyses, private accounts “are expected to earn an annual return of 3.0 percent [above inflation],” after adjustment for risk.¹³ Risk adjustment makes the balances in private accounts (which are subject to market risk) comparable to the value of the guaranteed Social Security benefit (which is not subject to market risk). Without adjusting for risk, comparing the certain balance in a traditional benefit to the uncertain balance in a private account is misleading.

From the perspective of risk adjustment, workers would not come out ahead if they opt for private accounts. Private accounts simply introduce substantial additional risk into the core tier of retirement security without doing anything to lessen the sliding-scale benefit reductions the President is proposing.

D. The Impact of the President’s Proposal on National Savings

Raising net national savings should be a fundamental goal of any proposal to reform Social Security and pensions. This goal was unanimously accepted by the 1994-96 Advisory Council and endorsed by the President’s Commission to Strengthen Social Security. Higher national savings leads to increased investment and/or reduced foreign borrowing. Either way, higher savings is the only way to increase consumption by the elderly without reducing consumption by the young.

The President’s accounts proposal (by itself and not counting the benefit reductions) does nothing to raise national savings and could even result in lower national savings.¹⁴ The President’s plan would put money into accounts (representing saving) while contemporaneously financing these contributions with higher federal borrowing (representing dissaving). The net effect would be no increase in savings.

One of the leading public finance textbooks, written by the former Chairman of President Bush’s Council of Economic Advisers Harvey Rosen, explains that “privatization” by itself does not raise national sav-

¹⁴ The benefit reductions in the President’s plan could lead to modest increases in national savings over time, although they would do relatively little to pre-fund Social Security by substantially increasing up-front savings. This subsection is concerned with the question of whether the accounts in the President’s proposal would further or set-back the effort to increase national savings.



ings:

Hence, privatization can help finance future retirees' consumption only to the extent that it allows future output to increase. And the only way it can do this is by increasing saving.

*However, there is no reason to believe that privatization by itself would raise national savings. The government by itself has to finance its deficit one way or another. In order to induce private investors to accept government bonds that would have been bought by the Trust Fund, their yield has to go up (increasing the debt burden on taxpayers), or the yield on stocks must fall, or both. At the end of the day, all that takes place is a swap of public and private securities between the Trust Fund and private markets – no new savings is created.*¹⁵ (emphasis added)

The primary effect of the President's accounts proposal is no change in national savings. As a result, the proposal fails to meet one of the principal goals for Social Security reform – increasing national savings. Further, two secondary effects could be important.

First, the accounts would reduce savings if individuals treat them as net wealth and consequently decrease their 401(k)s and IRAs savings. The completely rational actor that inhabits economics textbooks should not change his or her savings as a result of the accounts: every dollar contributed to the account is matched by a dollar reduction in present value terms in future Social Security benefits. As a result, the accounts do not represent net wealth but are instead a loan. Workers will still need to save as much of their own money to enjoy a dignified retirement. But, the design of the President's accounts (and the way in which they are often described) could lead many people to ignore the benefit offset associated with the account and to incorrectly assume that the accounts represent new wealth. Such people could feel less need to save in the form of 401(k)s and IRAs.¹⁶ This would not just reduce national savings, it would also leave these people even less prepared for retirement.

Second, in theory the accounts could increase savings if the higher deficits

¹⁵ Harvey S. Rosen, *Public Finance*, Seventh Edition, 2005, p. 208. Rosen goes on to explain that "sophisticated schemes" that include additional out-of-pocket contributions could increase savings. The President's carveout accounts do not have any of the features Rosen identified as leading to higher savings.

¹⁶ Douglas Elmendorf and Jeffrey Liebman provide evidence suggesting that individuals reduce savings by about 40 percent of the value of individual accounts but only increase savings by 25 percent for future reductions in Social Security benefits (like the benefit offset). As a result, they conclude that "individual accounts are likely to crowd out some other household saving." Douglas W. Elmendorf and Jeffrey B. Liebman, "Social Security Reform and National Saving in an Era of Budget Surpluses," *Brookings Papers on Economic Activity*, 2:2000.

associated with accounts lead to lower government spending and/or higher taxes. In this case, the government would not be completely financing the accounts with borrowing and national savings would increase. This theory depends on the behavior of the current government and future governments. The Bush administration has not claimed that if accounts were passed it would propose additional reductions in federal programs or higher taxes to offset the increased deficit. In fact, administration officials emphasize that they do not believe there is any need for such steps because, they contend, the accounts are fiscally neutral over the infinite future. In addition, the Bush administration has not included the short-run deficit impact of the accounts in its budget submissions. It would be imprudent to base a major policy on the hope that future government spending and/or taxes would change as a result.

Consequently, the President's accounts proposal, by itself, is likely to reduce national savings permanently. Even with the potentially offsetting effect of the sliding-scale benefit reductions, national savings would likely be lower and America as a whole would be poorer for several decades.

III. Alternative Approaches to Saving Social Security and Encouraging Savings

An alternative to the President's approach would advance all four goals simultaneously: make Social Security solvent, reduce the debt, protect retirement security, and increase national savings.

A. Saving Social Security

Social Security faces a projected deficit of \$4 trillion over the next decade. There is no way to restore solvency without some combination of benefit reductions and tax increases that total \$4 trillion. While neither half of the equation is politically pleasant, both should be part of any sound reform.

Several proposals have been advanced that would make modest changes to Social Security's benefits and taxes in order to restore solvency. One of the most promising proposals was developed by Peter Diamond and Peter Orszag.¹⁷ Specifically, Diamond and Orszag advocate steps that fit into four categories:

- **Addressing increased life expectancy.** Diamond and Orszag point out that the natural response to living longer is a combination of benefit reductions (i.e., reduced consumption in retirement), tax increas-

¹⁷ Peter Diamond and Peter Orszag, *Saving Social Security*, Brookings Institution Press, Washington DC: 2003.



es (i.e., reduced consumption during working years) and retiring later. Unlike many plans which advocate reducing benefits to cope with longer lives, Diamond and Orszag sensibly propose dividing this adjustment between payroll tax increase and benefit reductions.

- **Adjusting for increased earnings inequality.** Part of Social Security’s deteriorating financial outlook is the result of increased earnings inequality. As a result, more earnings are falling above the payroll tax cap and thus no longer represent Social Security revenue. Diamond-Orszag, like several other plans, propose to remedy this by gradually raising the cap.
- **Sharing the legacy debt.** Social Security was established as a pay-as-you-go system. As a result, the first generation got windfall benefits – and the system accrued what is known as “legacy debt.” Any plan, with or without accounts, will need to repay, or at least stabilize, this legacy debt. Diamond-Orszag propose to do it with modest benefit and tax changes combined with a “legacy charge” on earnings above the payroll tax cap, currently \$90,000.
- **Improving social insurance.** Several low-cost steps could improve Social Security’s ability to reduce poverty, including making benefits more generous for widows and strengthening the virtually non-existent minimum benefit.

An important consideration in designing a Social Security plan should be “robust solvency,” that is ensuring that Social Security remains solvent (and not overly solvent) even if we are currently wrong about our economic and demographic projections. Diamond-Orszag advances this goal by indexing benefits and payroll taxes to life expectancy. A further step would index some combination of benefits and taxes to the dependency ratio – that is the ratio of beneficiaries to workers. This is a more comprehensive demographic measure that reflects not only life expectancies but, even more importantly, delayed fertility and factors like immigration.

B. Making Saving Easier and More Rewarding

The median family approaches retirement with virtually no retirement savings. In part, this is because low-income families get few tax benefits for saving. More importantly, recent economic research has stressed that behavioral factors are a much more important determinant of savings than relatively small variations in the after-tax rate of return. While families often want to save more, often they are busy and do not take the necessary steps, or they plan to start saving next year. From this perspective, one of the major advantages of a 401(k) is that it makes it easier to save and helps to solve the procrastination problem.

An agenda to encourage more families to save should start with improving 401(k)s to make them more automatic, a process proposed by numerous economists including David Laibson, Bridget Madrian and Richard Thaler and advanced by Peter Orszag, William Gale and others. This proposal would make the default choice for participating employees a 401(k), unless the employee filled out a simple form opting out. In addition, the proposal would offer automatic escalation of payments, sensible and balanced options for automatic investment, and automatic rollover of the balance into an IRA after the employee departs. None of these steps would be coercive, they would simply embody a recommendation and make it easier for busy families to save. Any family that chooses not to save could continue to make this choice.

Second, it should be easier for families to save in IRAs. One step would allow workers to direct a portion of their tax refund into an IRA. In addition, the dozens of different savings accounts with different and confusing rules should be consolidated into one or two simple accounts.

Third, low-income families should be less penalized for their saving. Specifically, the asset tests for means-tested programs should be relaxed. Right now, low-income families have the lowest after-tax, after-transfer rates of return on savings. Instead, they should have the highest.

Finally, savings should be more rewarding for middle-income families. The saver's credit provides up to a one-to-one match for saving. This should be expanded and made refundable to ensure that all workers benefit.

It is critical that any steps to promote individual savings should meet two criteria. First, they should genuinely encourage new savings – and limit the windfall rewards for existing savings. The provisions to make savings easier would almost entirely lead to new savings and provide very little of a windfall for existing savers. Expanding the saver's credit would also be well advised because it targets moderate-income families, a group that saves relatively little today. In contrast, proposals to expand tax incentives for high-income families are likely to largely provide windfall rewards for existing savings.

Second, any new savings proposals should be fully offset by other tax increases or spending reduction and not add to the deficit. It would be counterproductive to advance retirement savings while setting back the attempts to address American's fiscal challenges. More importantly, a poorly targeted proposal might do little to increase private savings. If it is not offset, the resulting deficits could end up leading to a net reduction in national savings.



IV. Conclusion

Social Security faces a challenge and it is better to address this challenge sooner rather than later. But before tackling Social Security's long-term solvency, we should mind the words of the Hippocratic Oath and first, do no harm. Carveout accounts would do substantial harm: they would reduce the solvency of Social Security and add trillions of dollars to the debt while making retirement less secure and potentially reducing national savings. Add-on accounts that are financed by increasing the debt – either in the short run or the long run – would also be counterproductive and harmful.

A balanced set of reforms that modestly increases Social Security's revenues while modestly decreasing benefits could ensure that Social Security is sustainably solvent. Such reforms would help reduce long-term budget deficits and increase national savings. A series of reforms could also help strengthen retirement security by making it easier and more rewarding for families to save.