

Edited by Dallas L. Salisbury

ASSESSING SOCIAL SECURITY REFORM ALTERNATIVES



An EBRI ERF Policy Forum

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Library of Congress Cataloging-in-Publication Data

Assessing social security reform alternatives / edited by Dallas L. Salisbury
p. cm.

Includes bibliographical references (p.)

ISBN 0-86643-087-3

1. Social security—United States. I. Salisbury, Dallas L.

HD7125.A783 1997

368.4'3'00973—dc21

97-13587
CIP

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Since its inception, EBRI's membership has grown to represent a cross section of pension funds; businesses; trade associations; labor unions; health care providers and insurers; government organizations; and service firms, including actuarial firms, employee benefit consulting firms, law firms, accounting firms, and investment management firms.

Today, EBRI is recognized as one of the most authoritative and objective resources in the nation on employee benefit issues—health care, pensions, and economic security.

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Preface

For decades, most retirees have viewed Social Security as a vital program. This is largely due to the fact that individuals have not saved enough themselves, or planned for retirement. The 1996 Retirement Confidence Survey found that less than one-third of retirees had done income or expense planning prior to actual retirement. Most did not even know what their Social Security benefit would be.

The papers in this volume provide a picture of the vital nature of the Social Security program. At the same time, they depict the long-term financing issues faced by the program due to changing demographics. The papers highlight the high level of public support the Social Security system receives, and current public concerns about the program's future.

The papers set forth a framework for: analysis of reform options; details of work done by the Employee Benefit Research Institute (EBRI) to facilitate analysis and commentaries on its work; details on the various reform proposals setting the stage for current public policy debate; and assessments of the implications for the future.

This policy forum was the 40th in a series begun in 1979. Our mission: to contribute to, to encourage, and to enhance the development of sound employee benefit programs and sound public policy through objective research and education. The EBRI Social Security Reform Project is a multi-year effort to ensure the availability of objective research tools as the nation grapples with the future of this vital "employee benefit" program.

I wish to thank the contributors and the larger group of forum participants for making the

session stimulating and insightful. I also wish to thank EBRI Members for making the forum possible, and those who have made special grants for the Social Security Project: American Compensation Association, Amoco Foundation, AT&T, AT&T/Actuarial Sciences Associates, Inc., Barclays Global Investors, CIGNA Corporation, Citibank N.A., Goldman Sachs & Co., Hewitt, ICMA Retirement Corporation, Investment Company Institute, Milliman & Robertson, Inc., Mobil Oil Corporation, National Taxpayers Union Foundation, Pacifica Telesis Group, Principal Financial Group, SBC Communications, Inc., State Street Bank and Trust Co., TIAA-CREF, United Food & Commercial Workers Union, William H. Donner Foundation, and Zurich Kemper Investments, Inc.

This publication would not have been possible without the work of Bill Pierron and Pam Ostuw, who administered the forum; the noble efforts of Deborah Holmes, Lynn Miller, Maureen Richmond, and Cindy O'Connor in copy editing, proofing, and publishing the volume; and all the members of the EBRI team for providing many forms of support. In the end, however, I take sole responsibility for any errors or omissions.

The views expressed in this book are solely those of the authors and participants. They should not be attributed to officers, trustees, EBRI Members, its staff, or its Education and Research Fund. In publishing this book, EBRI-ERF is making no effort to influence any specific legislation. Comments on the contents and suggestions for work that we might undertake in the future are encouraged.

Dallas L. Salisbury
EBRI President
May 1997



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Assessing Social Security Reform Alternatives

by Christopher R. Conte

■ Introduction

The report of the 1994–1996 Advisory Council on Social Security settled one thing: we stand at a crossroads in deciding the future of the nation’s retirement system.

But we are ill-prepared to choose which path to take. The options proposed by different factions of the divided council—large-scale government investment in the stock market, a new mandatory savings plan for individuals, or partial “privatization” of the current system—would lead us in profoundly different directions. Yet we understand only vaguely the impact each would have on our retirement security, social relationships, and economy.

On December 4, 1996, the Employee Benefit Research Institute (EBRI) hosted a policy forum to explore how we can better assess these and other Social Security reform alternatives. The session, partly an exploration of the intricacies of mathematical modeling and partly a preview of policy debates to come, gave some of the nation’s leading authorities on Social Security a first look at SSASIM2, a state-of-the-art computer model that EBRI is developing to sort through the web of demographic, economic, psychological, social, and political factors that lie behind various proposals.

Their reaction could best be described as cautious enthusiasm: EBRI won praise for its bold effort but was reminded about the considerable uncertainties and guesswork involved in any project that is so complicated. Beyond that, many participants said, some of the biggest challenges will arise after the model is built, when the implications of its results will have to be interpreted for a public that has barely started to focus on the tough choices that lie ahead.

Still, it was widely agreed, the modeling exercise is an important start in what is sure to be a long journey. “When you begin to look at these

issues, you discover right away that a great deal of systematic analysis is necessary to even describe them,” noted William Beeman, vice president and director of economic studies for the Committee for Economic Development. “And even more sophisticated analysis is necessary to prescribe policies to deal with them.”

■ The Context: Pitfalls and Possibilities

In the most fundamental sense, the issues surrounding Social Security today are as old as the program itself. “Here we are again debating the role of social insurance in a market economy, trying to define the appropriate balance between individual and collective responsibility, [and] what is fair and efficient at individual, family, and aggregate society levels,” noted Robert Friedland, director of the National Academy on Aging.

These are difficult questions, but recent reform proposals pose analytical challenges far more daunting than the relatively modest, incremental changes that have been considered in the past. Instead of seeking a single change—an adjustment in the payroll tax rate or a rise in the normal retirement age, for instance—many current proposals would modify diverse parts of the system simultaneously and add entirely new elements, such as self-directed individual accounts, to Social Security’s traditional, defined benefit structure. To complicate matters further, reform advocates say Social Security should be judged in part by criteria that were hardly considered in the past, including whether it provides beneficiaries a favorable “rate of return” on their tax payments and whether it fosters economic growth by encouraging savings.

“The complexity of the proposals undoubtedly outstrips our ability to carefully analyze them at this point, and that’s the genesis of a model of this

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sort,” said Marilyn Moon, a Social Security trustee and senior fellow at the Urban Institute.

Against this backdrop, EBRI President Dallas L. Salisbury argued that we can’t continue to rely exclusively, as we have in the past, on either qualitative analysis or the work of the “extremely small” staff in the office of the actuary of the Social Security Administration. Noting that advocates of various reform alternatives employ tremendously different assumptions and methodologies, he described the Institute’s modeling exercise as “an effort to create an analytic capability that is able to do quantitative, apples-to-apples comparisons across proposals.”

While joining others in welcoming the undertaking, Moon added a note of caution, pointing out that there are pitfalls as well as possibilities in modeling. It’s often difficult to predict, she noted, whether trends from the past will continue into the future; can we assume, for instance, that women will continue to outlive men as they have in the past, even though recent experience suggests this may no longer be true? Moreover, she noted, some policies are particularly susceptible to modification after they are adopted, rendering earlier assumptions moot. If people are given ownership of their own Social Security accounts, she argued, they inevitably will seek to use those funds for activities other than retirement; what confidence can we have, then, about predictions concerning how many assets they will carry into the later years under such a reform? In other cases, totally unexpected factors can neutralize the impact of variables we know and understand.

“This is an interesting and important exercise but is an exercise,” Moon said. “We all know, those of us who engage in this, that we’re going to be wrong. We just don’t know how we’re going to be wrong.”

Other participants pointed out that models can be helpful even if they can’t tell us with certainty what will happen under different circumstances. Beeman, for instance, argued that they help force us to think more systematically. “There is a great deal of very loose thinking” about Social Security right now, he said, pointing out, for instance, that some reform advocates completely ignore the potentially sizable transition costs their proposals would entail.

Martin Holmer, who is president of Policy

Simulation Group, EBRI’s contractor in developing the Social Security simulation model, suggested that one of the greatest values of models can be to show us not what the future will bring but rather where the greatest risk of unanticipated or unwanted outcomes lies.

Holmer gave conference participants a “look under the hood” at how the EBRI model works. It starts with the same demographic and economic assumptions used by the Social Security Administration but adds some variables, such as return on equity, that haven’t traditionally been considered relevant. It also analyzes some issues, such as the likely return on individual investment accounts, that are beyond the scope of the current program.

Most significantly, the EBRI model employs “stochastic,” or “Monte Carlo,” techniques, which enable analysts to develop not a single projection—or, in the case of the Social Security Administration, “low,” “high” and “intermediate” projections—but rather a whole range of possible outcomes. Using probability theory, the model then shows the chances of various outcomes actually occurring. This is an improvement over traditional methods, most participants agreed, because it shows the odds that things will turn out worse, or better, than projected. With that information, policymakers can design reforms that “hedge” against the biggest risks, Holmer said.

■ The Mortality Debate

One example of the uncertainty surrounding the modeling process is the assumption we must make concerning the mortality rate. The Social Security Administration assumes that mortality will decline at a far slower rate in the future than it did during the 20th century. But this view is controversial, noted Jack VanDerhei, associate professor at Temple University and research director for EBRI’s Fellows Program. While the intermediate projection by the Social Security actuaries assumes that the number of people over age 85 will rise to 14.6 million in 2050 from 3.3 million in 1994, the Census Bureau puts that figure considerably higher, at 18.2 million. Running the Census Bureau figures through SSASIM2 suggests that Social Security’s actuarial deficit will rise to 7.05 percent of taxable payroll in 2070, compared with the 5.52 percent projected by the Social Security

Administration.

James Smith, senior economist at the RAND Corp., said even the Census Bureau figures underestimate the probable decline in mortality. He said a reasonable forecast would be that the number of people over age 85 could total 21 million by 2050 and that some “reputable scientists” believe it could reach as high as 50 million, more than triple the Social Security Administration’s estimate. Moreover, Smith said official estimates fail to account for the fact that higher-income people tend to live longer than low-income people, thus adding disproportionately to benefit costs. That factor alone could drive costs 10 percent above official projections, he argued.

Stephen Goss, deputy chief actuary for the Social Security Administration, defended the agency’s mortality assumptions. Not long ago, he said, a technical panel found that if Social Security were to change its mortality assumptions, it would have to adjust them for people of all ages, not just for old people. But a lower death rate among young people would mean there will be more workers than expected paying payroll taxes, thus negating much of the adverse financial consequences of larger population of senior citizens. Moreover, according to Goss, the same panel found that the government had underestimated future fertility rates, neutralizing the effect of changed mortality figures entirely.

To hedge against the possibility of larger-than-anticipated gains in life expectancy, Holmer noted, the government of Switzerland has been exploring the idea of indexing benefits to age expectancy for different cohorts of the population. A less precise variation of this strategy, of course, would be simply to increase the normal age of retirement for Social Security purposes. Robert Myers, who spent 23 years as chief actuary for the Social Security Commission, recommended just that. Raising the retirement age to 70 by the year 2037 shouldn’t even be considered a cut in benefits, he argued, since by then a person who retires at that age will have the same life expectancy as someone who retires at 65 today.

■ Predicting Rates of Return

If Social Security actuaries have trouble projecting long-term mortality trends, which they have studied since the program’s inception in 1935, how

much harder would it be to estimate what returns the system could expect by allowing equity investment?

All three factions of the advisory council assume that the historic advantage of equities over bonds will continue in the future (in recent decades, the yield on equities has averaged 7 percent more than inflation, while Treasury bonds have paid only 2.3 percent more). But Robert Shapiro, founder and vice president of the Progressive Policy Institute, warned that projecting future investment returns, for markets as a whole and especially for individual investors compared with other individual investors, will be very hazardous. “I question our ability to sensibly model behavior of financial asset and debt markets over time,” he said.

For individual accounts, in particular, how individuals allocate their assets among different types of assets will be a crucial variable. On this point, at least, EBRI has a growing base of information on which to build the model. Salisbury noted that EBRI’s own defined contribution project now has data on how one million individual investors allocate assets in their retirement accounts, and that database eventually will grow to 10 million.

When it comes to asset allocation, the stakes, both for model-designers and investors, are very high. VanDerhei produced figures from the simulation showing that a “life cycle” approach to investing, in which a person puts his or her investments initially in equities and then gradually switches to bonds over time will produce substantially better results than maintaining a consistent allocation over an entire lifetime. But even in the second case, where the hypothetical worker puts 40 percent of his assets in equities, the pay-off would be higher than what would occur if the current Social Security structure were maintained and taxes were raised to cover rising benefit costs or if benefits were cut to fit the existing tax structure.

Significantly, the stochastic model also showed that returns under the privatization scheme would vary far more than under either of the “nonstructural” reforms. For critics of privatization, that was a crucial observation. “How about all the people who aren’t going to get average returns, and may even lose?” asked Robert Ball, former Commissioner of Social Security under Presidents Kennedy, Johnson, and Nixon and a critic of privatization. “I think we need to look at

the range of possible outcomes from these investments—particularly for low-income people—and worry about whether they’re tolerable.”

Girard Miller, president and chief executive officer of ICMA Retirement Corp., echoed that concern and added another: Will the Social Security “safety net” have to be extended to people who happen to retire during a bear market and hence have to cash in or annuitize their savings when their value is low? The possibility of such “cohort-specific” market losses concerns a number of baby boomers, in particular. Some analysts believe at least part of the run-up in stock prices in recent years is driven by the baby boom generation’s growing demand for equity investments to help finance retirement. If so, some worry that their retirement, and the resulting sell-off of their stock portfolios, could bring a long bear market.

“It’s been one of my constant worries that when I come to retire and sell my 401(k) plan, I’m not sure who I’m going to be selling it to,” said William Cheney, chief economist for John Hancock Mutual Life Insurance Co.

■ Macroeconomic Effects

Privatization advocates believe Cheney’s fears won’t be realized. If workers are encouraged, or compelled, to save more, net investment would rise. If so, demand for the baby boomers’ portfolios could be strong despite the relatively smaller number of buyers. And, more importantly, increased savings would lead to higher productivity and faster economic growth, benefiting society as a whole, they argue.

That appears to be the premise behind a reform plan presented by the National Taxpayers Union. It would gradually phase out the existing Social Security system and replace it with a “national thrift plan.” Taxpayers would be required to set aside an amount equal to 5 percent of their wages in “personal thrift accounts.” The government would match contributions of low-wage workers, and guarantee a household income equal to the poverty level for all Americans over age 62.

While the plan would require sacrifices from current retirees by expanding taxation of benefits and reducing cost-of-living increases, Howe presented simulations that suggest its overall economic impact could be quite positive. Net national savings would quintuple to 5.9 percent of Gross

Domestic Product by 2065, raising productivity and average wages by as much as 26 percent, he said. And he suggested that such gains would enable workers at all income levels to receive much greater benefits than under the current system—all without new government debt, new taxes, or unrelated reductions in government spending.

“The savings-productivity-real wages link is absolutely essential,” argued Neil Howe, a consultant who presented the taxpayer group’s plan. “It’s this link that keeps Social Security reform from turning into something close to a zero-sum game.”

Eugene Steuerle, a senior fellow at the Urban Institute, was skeptical about the economic-growth argument. Switching Social Security reserves out of government securities and into the stock market could unsettle the bond market and drive up interest rates, especially if other governments were to follow the federal government’s lead, he said. More fundamentally, the retirement of the baby boom generation will result in a drop in “human capital” equal to a 20 percent or 25 percent rise in unemployment. Steuerle argued that it’s hard to imagine any level of capital investment that would produce enough economic growth to boost incomes high enough to offset that dampening effect on the economy.

“I don’t think you can build enough steel mills to solve this problem,” he said.

Even the assumption that the reform proposals would increase savings needs to be tested, Steuerle added. If the government creates incentives or requires more savings through Social Security, he suggested, people might simply reduce their savings outside the system by a comparable amount. As a result, reform proposals aimed at increasing savings could wind up having “very little effect.”

While voicing doubts that Social Security reforms will have much impact on economic growth, Steuerle joined most forum participants in urging EBRI to press ahead in its study of the issue. The RAND Corporation’s James Smith, for instance, argued that making no change in the program could have economic consequences just as significant as various reform proposals. According to Smith, the tax rate to pay for Social Security, Medicare, and other age-related transfers could climb to 40 percent during the next century if current trends continue. That would lead to tremendous pressures to cut other categories of government spending and

could even choke off economic growth altogether.

“We have to be talking about encouraging savings and growth,” Smith said. He proposed imposing a progressive consumption tax.

Robert Myers, however, dissented from the general sentiment that reform proposals should be judged partly by what effect they would have on the overall economy. “Social Security does not have the purpose of solving all national problems,” he said, adding that economic growth, in particular, is “not Social Security’s responsibility.” The real purpose of the retirement system, he said, is to ensure all retirees a basic “floor of protection.”

The importance of that floor was underscored by Robert Friedland, who noted that 61 percent of today’s elderly—72 percent of those over age 75—derive at least one-half of their income from Social Security. Similarly, James Smith noted that one-half of all retirees over age 70 have financial assets totaling \$10,500 or less. For those aged 51–61, the situation isn’t much better; the median level of financial assets for that group is \$17,300.

Smith also argued that the current Social Security system isn’t as progressive as it appears. Conventional figures on life expectancy suggest that the typical minimum wage recipient will receive lifetime benefits equal to a 4 percent rate of return on his Social Security tax payments, compared with a 1.5 percent return for somebody whose wages equal the maximum subject to Social Security taxes. But if the figures are adjusted to reflect the shorter life expectancy for low-income people, the minimum wage recipient will realize a rate of return of only 3.1 percent, just slightly ahead of the 2.4 percent return for a wealthier person collecting the maximum in benefits, Smith said.

■ The Perception Gap

While trying to untangle all of these analytical questions might seem to be challenging enough, several forum participants suggested that EBRI’s job won’t be finished even after its model is built.

“Ultimately, what we want to do is try to find ways to understand the implications of various options and then to be able to explain them to people in ways that are meaningful,” Moon said. “There’s a translation that going to need to be made here.”

She argued that many Americans don’t fully understand concepts like risk, the trade-off between risk and return, and second-order effects, all of which are crucial to the analysis of policy alternatives. “My caution today would be that we not be too charmed with the elegance of the models and we opt for utilitarian approaches whenever possible.”

Susan Dentzer, chief economics correspondent for U.S. News and World Report, underscored Moon’s warning. “There is a very large potential perception gap between many of us who work on these very abstruse levels and the way these things are likely to be perceived by the public,” she said.

In particular, Dentzer questioned whether many Americans understand financial matters sufficiently to invest their own Social Security funds. She also suggested that the “linchpin” of privatization, the assumption that an “appropriate” annuities market will develop and be capable not only of having reliable returns but of securing investments once people retire, is far from assured. “Just hearing from financial market participants that it will take care of itself, frankly, does not increase my confidence that this is a salable plan,” she said.

Even some analytically straightforward Social Security reforms won’t be easy to sell, Dentzer added. Raising the retirement age, for instance, will be a “very, very difficult political proposition indeed,” she said. And she warned that there is a greater potential for “perceived social injustice for different classes of individuals” in various reform proposals than experts recognize.

A number of forum participants urged EBRI to use its model not just to assess reform alternatives but also to develop a better understanding of the current Social Security system. Supporters of the existing system, for instance, voiced concerns that the public misunderstands the system’s condition, believing it is in worse shape than it really is. Myers dismissed as “myth” the belief that Social Security will go bankrupt sometime around 2030; in fact, he said, the system’s low-cost estimate shows it will stay “in great shape” for the agency’s entire 75-year forecasting period. And members of the advisory council’s most traditionally minded faction point out that, even under the agency’s intermediate assumptions, Social Security still could cover three-fourths of its benefit costs after the year 2030 without any changes in policy.

Nevertheless, “no one has confidence, it

seems, that [Social Security] will be there,” Friedland noted. “I’m not sure that they really believe it....Most people have not thought much about Social Security...What little they know seems to what they’ve heard, and what they’ve heard comes from television and the newspaper and what they’ve heard is that the program is going broke.”

Gary Burtless, a senior fellow at the Brookings Institution, agreed that the press shares blame for the public’s gloom. Seven years ago, he said, he co-authored the book, *Can America Afford to Grow Old?* Even though he and his colleagues concluded that the answer was yes, most press accounts and book reviews said the answer was no. “I think that’s a congenital problem among journalists, who may reason they will never see their name in print if they write a story containing either good news or at least ambiguous news,” Burtless said.

In any event, the public is eager to be educated and is less susceptible to partisan efforts to exploit fears about Social Security or other entitlements than it has been in the past, according to political analyst and commentator Charles Cook. “They understand that we have some very serious problems with our entitlement programs,” he said. In a review of the 1996 elections, Cook argued that the Democrats succeeded for a time in charging that Republicans would cut too deeply into Medicare and other entitlement programs, but the issue “evaporated” toward the end of the campaign. In the final analysis, he said, Democratic claims didn’t change the outcome of any congressional race in the country. And, he said, people will require proof before they allow themselves to be frightened by such claims in the future.

Cook said he didn’t believe the political climate was particularly favorable for entitlement reform, though. He predicted that many Republicans, feeling burned by the Democrats’ charges that they would wreck Medicare, probably will sit back and force President Clinton and his party to take the lead on the issue. Many congressional Democrats, meanwhile, don’t feel a great sense of urgency about the matter.

When forced to act, many lawmakers will jump at easy solutions like making technical adjustments in the Consumer Price Index that would slow cost-of-living increases in Social Security benefits, rather than enacting more fundamental reforms, Cook predicted. Doing something that

appears painless, or that pins the blame on somebody else “would be very, very, very appealing to most political people,” he said.

■ Reform Alternatives

Participants in the EBRI forum weren’t offering many painless solutions, though. During the final phase of their discussion, they examined specific reform proposals, in the process demonstrating that while policy prescriptions can be significantly influenced by the results of economic modeling, they also are shaped significantly by views and judgments that transcend science.

Some described the issue as essentially a moral one. Myers, who argued forcefully that Social Security isn’t “broke” and shouldn’t be “thrown away,” recommended raising the normal retirement age for Social Security to 70 by the year 2037 and increasing the payroll tax by 1.2 percentage points for both employers and employees between 2015 and 2035. He suggested normal economic growth should increase incomes enough that people easily could afford such a tax hike. “But even if they didn’t rise, do Americans have to be so unaltruistic” as to oppose such an increase, he asked. “Do they have to be so concerned that they always have rising incomes and have five cars in every garage and three television sets in every room?”

Many others based their reform plans on a blend of economic analysis, value judgments, and realpolitik. Robert Ball, for instance, who was part of the advisory council group that recommended direct government investment in the stock market, seemed to defend the proposal more on political than financial grounds.

“We have to do something about the perception of younger people that they’re not getting a good deal under Social Security,” Ball said. “For the security of the system, the people who are going to vote in the future need to understand and support it and believe they are being treated fairly.”

Most of the projected Social Security shortfall, Ball argued, could be covered in “quite traditional ways” without changing the system’s basic structure. His “maintain benefits” group on the advisory council recommended, as first steps, extending Social Security coverage to state and local government employees, tighter taxation of Social Security benefits, modifying Social Security cost-of-living to

reflect changes in the Consumer Price Index, and other changes.

But Ball acknowledged that all of these changes together won't get the system completely past the financial challenges posed by the retirement of the baby boom generation. Ball's group said the payroll tax would have to be increased around 2050. It also recommended taking a serious look at the idea of investing up to 40 percent of Social Security tax collections in the stock market.

Ball said the government should do the investing, rather than individuals, so as to maintain support for Social Security as a social insurance program. Allowing people to set up individual accounts in Social Security would sew the "seeds of destruction" for the system as a whole, he argued because "average and above-average investors," able to earn higher returns on their self-directed accounts than on the traditional part of the Social Security program, would demand that more and more funds be switched from the regular benefit program into individualized accounts.

Lawrence Thompson, principle deputy commissioner of the Social Security Administration, presented the case for so-called "individualized accounts" with a different combination of economic thinking and practical politics. His starting point was that some combination of higher taxes and reduced benefits is inevitable. "If people are going to live longer, either they're going to have lower benefits in retirement, they're going to put more away each year while they're working, or they're going to have to work longer," he said.

The individualized accounts proposal was developed by Edward Gramlich, dean of the school of public policy at the University of Michigan and chairman of the advisory council. It essentially would "split the difference" between benefit cuts and tax increases, Thompson said, by trimming benefits to a level that could be supported by the current payroll tax and requiring individuals to pay an additional 1.6 percent of payroll into individual accounts. While individuals would have some control over how funds in their accounts would be invested, the choices would be limited, the money would be managed centrally, and all benefits would have to be paid out in the form of indexed annuities.

Thompson said the public wants greater individualization. But he said limiting investment choices would help minimize the risk that workers

would reach retirement with insufficient savings. That's especially important, Thompson argued, because risk has increased in the private sector as many employers have come to favor defined contribution plans over defined benefit plans. "If the private sector is getting riskier, we should be very cautious about transferring a whole lot more risk onto individual workers by significantly shrinking the public system," he said.

While Ball and Thompson were concerned about maintaining a strong role for the government in the retirement security realm, Ann Combs, a principal with William M. Mercer, Inc., and a member of the advisory council, made it clear that a desire for less government underlies privatization proposals. Combs was part of the advisory council faction that developed the so-called "personal savings account" proposal. It would allow workers effectively to put 5 percent of their payroll earnings into the personal accounts, which they would be free to manage and wouldn't have to annuitize when they retire. The remaining 7.4 percentage points of the payroll tax would be used to pay a flat benefit to all retirees, initially \$410 per month. In addition, a tax equal to 1.52 percent of payroll would be imposed to help finance the transition from the current system to the new one.

Combs said the plan would guarantee retirees an income equal to two-thirds of the poverty level and would eliminate some of the complexity of the current benefit formula while creating a "very direct link" between taxes paid and benefits received. The personal savings accounts, meanwhile, would lead to increased financial literacy and possibly would encourage more saving, she said.

Advocates of this approach contend that the individual account plan would leave too much control in the hands of government. The "maintain benefits" proposal of Ball and others would be even worse in this regard, they argue. Although Ball said that government investment should be entirely passive in its approach to equities investment, Combs questioned whether politicians could resist the opportunity to let social objectives shape public investment strategy. "In the end, it's politicians who make the decisions and can rewrite the rules," she argued, "and I believe the temptation for social investing or targeted investing....will be too great."

And while Ball and Thompson warned against imposing more financial risk on retirees, Combs

argued that the new financial market risk on workers and retirees would be no greater than the “political risk” that they currently face—namely that the government will change the rules of the game by raising taxes or changing benefits.

■ What’s Next?

Given the sharp divisions among experts, the uncertainty about what impact various reform proposals would have, and the fact that Social Security’s projected insolvency is still some years off, EBRI should have plenty of time to complete development of its Social Security model. In the meantime, there’s a good chance we’ll see more experimentation and that may produce useful data the Institute can plug into its equations.

Stanford Ross, a senior partner in the law firm of Arnold and Porter and a former Social Security commissioner, proposed a cautious, pragmatic approach to reform that illustrates how we might evolve gradually toward a new Social Security arrangement.

The program should be brought into financial balance, Ross said, partly to calm the “sky is falling rhetoric” about the system. He also agreed that there should be a “personal account element”

because younger people are “less accepting of government paternalism.” But rather than setting out to solve the problem all at once, he said, we should first adopt many of the incremental changes that analysts like Ball have proposed and then let people voluntarily set aside additional funds in individual accounts.

“One advantage of a voluntary approach is it would give you valuable experience about how the people who would be affected really feel about putting away more for their retirement as opposed to consumption or other purposes,” he argued. “You would get valuable information.”

Ross’s recommendations, less comprehensive than other proposals, would leave many questions about the future of Social Security unanswered. But in a sense, they summed up the current state of policy analysis and policy making—including both our lack of information and the need for greater understanding between the public and experts. Without these, consensus may remain elusive.

“Any changes are going to have to be broadly bipartisan and based on a great deal of public education,” Ross said. “Different people make different calls on the economics and the politics and how they think people react to things.”

1

A Framework for Analyzing and Comparing Social Security Policies

by Kelly Olsen, Jack VanDerhei, and Dallas L. Salisbury

■ **OASDI's Finance Issues**

Under current law, the Social Security program will meet the retirement of the baby boom generation¹ in 2008, when the first boomers reach eligibility for early retirement benefits at age 62. This retirement wave will only exacerbate pre-existing demographic pressures, primarily the result of our aging society, maturing social insurance systems, and lower birth rates in cohorts succeeding the baby boom generation. In 1983, policymakers anticipated this long-range demographic strain by increasing the normal retirement age (NRA) and by raising Social Security taxes. Recalculating tax rates, policymakers averaged the combined Old-Age, Survivors and Disability Insurance (OASDI) program's cost as a percentage of taxable payroll over a 75-year projection period, resulting in a tax rate higher than needed to fund short-term obligations.

In effect, this method of calculating the OASDI portion of FICA added a partial advance funding structure to the Social Security system that went beyond the historical practice of simply maintaining a contingency reserve. Due to the fact that, since 1983, FICA taxes have been higher than needed to meet current benefit payments, "surplus" Social Security revenue has been accumulated.

This revenue has been converted into Special-Issue Treasury bonds and credited to the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds, which are maintained by the Treasury Department. By the end of 1996, the OASDI trust funds had accumulated approximately \$566 billion in assets, an amount anticipated to peak at about \$1.3 trillion (in 1996 dollars) by the year 2015.²

Theoretically, the Social Security trust fund surplus will be drawn down as demographic pressures mount, helping younger workers pay for Social Security retiree benefits and thereby keeping future FICA taxes lower than they would be if the system were maintained on a purely pay-as-you-go³ basis.⁴ Under intermediate assumptions, principal from the trust funds will begin to be used in 2019 to finance the portion of Social Security benefits obligations not funded by current FICA taxes. In the absence of reform, the 1996 Social Security Trustees' Report estimates that the trust funds will be depleted in 2029. At that time, FICA revenues alone will be able to finance only about three-fourths of benefit obligations for the remainder of the 75-year projection period (2029 through 2070).

Few among the general American public realize that trust fund balances are dwindling by

¹ Persons born between 1946 and 1964.

² See Board of Trustees, 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, DC: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1996). The trust funds held about 13 months of Old-Age, Survivors and Disability Insurance (OASDI) benefits in reserve at the end of 1996. Under intermediate assumptions, the trust fund is expected to peak with holdings of about 25 months worth of benefits by the end of 2005. Under the same assumptions, the trust fund is projected to hold about 13 months of benefits in reserve by 2015.

³ A pay-as-you-go system is one in which all FICA taxes collected today are used to pay for all Social Security benefits due today. That is, in a pay-as-you-go system, the only money used to pay current benefits is money collected from current workers' wages.

⁴ Note that the assumption that trust fund surpluses will help future workers fund future benefits has never been unanimously accepted. See Alicia Munnell and Lynn Blais, "Do We Want Large Social Security Surpluses?" *New England Economic Review* (September/October 1984): 5–21, and Robert Myers, "Social Security and the Federal Budget: Some Mirages, Myths, and Solutions," *Journal of the American Society of CLU and ChFC* (March 1989): 58–63.

Assessing Social Security Reform Alternatives

legislative design, and, therefore, falling trust fund balances are not “news.” The real news about the trust funds is that they were not expected to dwindle as quickly as current projections predict. After passage of the Social Security Amendments Act of 1983, the 1983 Social Security Trustees’ Report projected that the trust funds would hold 54 percent of outlays in reserve by 2060 under the second set of intermediate assumptions (Board of Trustees, 1983). In contrast, intermediate assumptions used in the 1996 Social Security Trustees’ Report project the OASDI trust fund balance to be exhausted by 2029.

Although legislative changes from 1983 to 1995 and more optimistic demographic assumptions had positive implications for the combined OASDI trust fund balances, these were outweighed by other factors. The markedly more negative projections in the OASDI Trustees’ reports from 1983 to 1996 are attributable to use of stricter actuarial methodology in calculating trust fund balances, a change to more pessimistic disability and economic assumptions, and other changes.⁵ An additional contributing factor is that the period projected in the 1996 report includes 12 deficit years in which demographic pressures will be strong (see following table).

Because, as a whole, the 1983 Trustees’ assumptions are optimistic in retrospect, some are concerned that 1996 Trustees’ projections are optimistic as well and are therefore understating the OASDI long-range financial shortfall.⁶

In addition, critics of the current system argue that the trust funds are already essentially depleted because their assets are borrowed by the federal government (i.e., Congress), which uses them to finance other government operations. When the OASDI program’s Treasury bonds must be redeemed in order to pay benefits, the only way

⁵ For example, the revised test to determine the trust funds’ long-term financial condition became stricter in 1992, and the methodology used to generate the economic assumptions was also changed. See Michael Anzick, “1991 Social Security and Medicare Annual Reports Revise Insolvency Projections,” Employee Benefit Notes (August 1991): 1–8. The change in assumption generation means that “assumptions for the future have been revised in a less optimistic direction.” See Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century* (Washington, DC: Urban Institute Press, 1994).

Table 1.1
**REASONS FOR CHANGING TRUST FUND BALANCES,
1983–1996**

75 Year Actuarial Balance in 1983 OASDI^a Trustees’ report = +0.02
75 Year Actuarial Balance in 1996 OASDI^a Trustees’ report = –2.17
(as a percent of taxable payroll) Change in Balance = –2.19

Reason for –2.19 Change in Actuarial Balance	Amount and Direction of Change
Legislation	+0.10
Valuation Period	–0.55
Economic Assumptions	–0.79
Demographic Assumptions	+0.83
Disability Assumptions	–0.70
Methods	–0.93
All Other	–0.15

Source: Office of the Actuary, Social Security Administration, 1997.
^aOld-Age, Survivors and Disability Insurance.

for the government to repay its loans will be to borrow money from other sources, increase general taxes, or reduce other areas of government spending. In any case, assuming that trust fund assets will need to be tapped in order to pay benefits, general tax revenues are likely to rise. This leads many to speculate that the combined OASDI trust fund “isn’t really there” in the sense that the money current workers are paying today in excess of current benefit obligations is not going to help rein in overall tax rates tomorrow. Others argue that overall tax rates would be the same or even steeper in the future if the government had borrowed money from higher-interest lending sources in the private sector or had raised current income taxes instead of borrowing OASDI trust fund reserves. Conversely, some speculate that the federal government would not have expended as many resources had the Social Security trust funds not been available.

Whatever one’s perspective on the trust fund reserves’ efficacy in prefunding OASDI benefit

⁶ In particular, program solvency is most sensitive to mortality and nativity assumptions, an area of controversial debate even within the federal government. For example, the Census Bureau’s mid-range projections predict 3.6 million more persons aged 85 and over by 2050 than the OASDI Trustees’ mid-range assumptions. Some academics project that numbers will be even higher. See “U.S. Population Projections: 2050 Ages 85 and Older,” National Institute on Aging and Census Bureau estimates, 1996.

obligations, projections show that the current FICA tax rate alone will be able to cover about 76 percent of projected program liabilities by 2029 (Social Security Administration, 1996). Therefore, without raising additional Social Security revenues, beneficiaries in 2029 may receive only about three-fourths of what they are currently promised. The projected deficit over the 75-year actuarial period from 1996 to 2070 is expected to be 2.17 percent of taxable payroll under intermediate assumptions;⁷ that is, if payroll taxes were increased by this amount in 1996, a 17.5 percent increase, the combined OASDI program would be solvent until 2070. Were the Congress to wait until 2022 to increase taxes without cutting benefits, taxes would have to rise 4.33 percent to 16.7 percent of taxable payroll, about a 35 percent increase, in order to keep the program solvent until 2070.⁸

As a result of this projected shortfall by 2029 of roughly one-quarter of benefits promised, numerous and diverse reform proposals have been promulgated. Depending on their supporters' beliefs about the merit and viability of the current system, these reforms range from fixing the Social Security system in more traditional ways to transforming the existing system into a fundamentally different one (Advisory Council on Social Security, 1997). The November 1996 issue of *EBRI Notes* summarizes the main parameters of seven such reform packages (Olsen, 1996).

This paper provides a framework for evaluating and comparing Social Security policies by delineating 11 broad areas of consideration and highlighting some of the relevant questions within these areas. This framework is not a comprehensive list of all considerations but is intended to provide a feel for their complexity and to highlight some of their most popularly recognized interactive possibilities. As an introduction to EBRI's Social Security Reform Analysis Project, this chapter sets the theoretical framework in which to place the

forthcoming technical results from the EBRI-SSASIM2 Policy Simulation Model. This model will produce stochastically generated quantitative data regarding specific reforms.

■ Policy Evaluation

Sorting through the multitude of information about Social Security proposals in order to fairly and comprehensively compare and evaluate them can be daunting. Those who do not abandon the effort altogether are often tempted to make it more manageable by focusing on only one or two aspects of policy analysis, often spiraling into enormous detail. Not only does this “blinders” approach risk losing the forest for the trees, but those who focus on only a few policy considerations inevitably fail to appreciate the interrelated nature of social programs, economics, and other aspects of society. A change in one aspect of a policy may not only resound throughout all its operations but may also resonate into other policy areas, affecting ostensibly unrelated aspects of the nation.

If nothing else, the complex evaluation framework delineated here is testimony to the potential shortcomings of any proposals, regardless of their supporters' intentions or political alignment, that offer professedly simple and sacrifice-free answers to Social Security's finance issues. In addition, the framework lends itself to varying depths of analysis and comparison by presenting both broad areas of consideration and by enumerating specific questions within these areas. It should therefore be a useful guide to both informed citizens and policy analysts.

There are three broad areas to consider in comparing Social Security policies. The first is identification of the policies' underlying philosophies and assumptions that affect policy goals. Second, the nuts-and-bolts structure of each policy must be ascertained. Knowing the specific parameters of a plan provides a starting point for predicting programmatic outcomes (i.e., the possible or likely effects of the program for all those affected), the third broad area of consideration.

■ Underlying Benefits

Differing ideas about the appropriate goals of Social Security policy emerge from varying underlying assumptions about political, economic, and

⁷ See Board of Trustees, 1996. It is interesting to note, however, that the 1996 Social Security Advisory Council assumes an adjustment of the consumer price index of 0.21 percent, which decreases the expected shortfall from 2.17 percent of taxable payroll to 1.86 percent. See Advisory Council on Social Security, Report of the 1994–1995 Advisory Council on Social Security, Vol. I (Washington, DC: 1997).

⁸ *Ibid.*

other human behaviors. In addition, policy advocates differ in their assumptions about demographics and their views on desirable public policy goals, including beliefs about the appropriate delegation of responsibility between government and workers in providing retirement income security. The former difference is perhaps most pronounced in the current debate, and is reflected in the fact that reform packages range in fundamental design from those that would alter Social Security while maintaining the current defined benefit system (i.e., a social insurance system that pools risk) to those that would supplement or replace the current system with defined contribution (i.e., individual) accounts that return each dollar directly to the “family” that contributed the dollar.

Dissent about the appropriate responsibilities of government and workers in providing retirement income can often be traced to differing basic beliefs about human nature and government. This is an especially pronounced difference that arose among members of the 1994–1996 Social Security Advisory Council when it agreed to increase advance-funding for the OASDI program. In part because of differing beliefs about who should maintain and manage advance-funding reserves—individuals or government—the Advisory Council ended up factionalized and proposed three different plans.

Related questions that bear relevance to the design of Social Security policy include: are people forward-looking and able to defer gratification in order to plan for their own retirement; how much paternalism do people require in order to act in their own best interests; how willing and able are most Americans to inform themselves about and adjust to a new type of Social Security system? The answers to these questions affect one’s policy goals because they are directly related to beliefs about how private individuals will respond to public policy change. Similarly, opinions about government workers and political leaders influence predictions of how the government will respond to a new policy.

Fundamental assumptions about the availability and efficient control of economic resources is also at the heart of much of the current Social Security debate. How much can America afford to spend on Social Security while still tending to other “important” areas? In short, how much money is there to “go around?” How does government

intervention in redistributing resources affect economic growth? What is the inherent capacity of the private market to resolve or prevent social problems? Who is better at efficiently managing money, providing retirement security, mitigating risks, etc., the government or the private sector?

Approaching reform from different underlying philosophies means that advocates are at risk of debating on entirely different planes. While it is impractical in time-constrained debate to focus heavily on identifying and evaluating advocates’ underlying beliefs and attitudes, comprehensive policy analysis and comparison mandate recognition of the impact they have on plan goals, on policy discourse, and ultimately, on retirement income policy and outcomes.

■ Program Parameters

The most fundamental structure in any retirement income policy is basic plan design. After this is established, many aspects of how the program raises revenue and provides benefits follow. In short, the broad parameters of a policy are plan design and program finance.

Basic Plan Design

Retirement income plans are designed as defined benefit, defined contribution, or a combination of both. In a defined benefit plan, such as the current Social Security system, the goal is to guarantee that, if workers participate, they receive benefits in an amount dictated by a predetermined formula. The government theoretically assumes complete responsibility for fulfilling Social Security’s promises by mandating contributions and by guaranteeing benefit levels. To guarantee benefits, contributions may have to increase over time.

In a defined contribution system, the plan sponsor’s goal is to specify a method for determining the cost of an individual account while providing more participant choice. A consequence of greater choice is that the sponsor (in the case of OASDI, the government) is absolved from responsibility for guaranteeing benefit levels at retirement. Although the government or employer may set the range of investment options available, participating workers shoulder responsibility for investment gains and losses and therefore assume ultimate responsibility for at least one part of their retire-

ment security.⁹ Possible risks involved with being ultimately responsible for one's own retirement income are discussed in the section titled Adequacy (see p. 16).

Nevertheless, the government would still play a large part in promoting retirement security under a defined contribution-style Social Security system. At minimum, the government would likely be responsible for providing or ensuring the availability of a vehicle for contribution collection and investment as well as a means of benefit distribution through a system of individual accounts. In most Social Security reform proposals using defined contribution accounts, the government is also responsible for enforcing participation and, perhaps, for providing savings assistance to lower-income workers.¹⁰

Program Finance

The finance parameter defines how a program maintains financial solvency. Traditionally, government reaction to projected shortfalls in a federal program has taken three forms: raising taxes ("contributions"), lowering expenditures ("benefits"), or issuing debt. In addition to these traditional methods, private market investment is now a popular proposal for dealing with OASDI shortfalls. This approach attempts to raise program revenue by taking advantage of stock market return rates through investment of Social Security program revenues and/or reserves in equities. It is assumed that stock returns will continue to be higher than bond returns.

Furthermore, some advocates of using defined contribution accounts in the Social Security system suggest offering or mandating defined contribution savings in addition to the current FICA tax payments. This is another nontraditional approach to maintaining program solvency in light of projected shortfalls. While similar to a payroll tax in that

mandated savings would reduce workers' current disposable income, optional or mandated savings would not transfer money from worker to government. Instead, optional or mandated savings rates would be deferrals of a share of current wages into personal property vehicles for retirement savings. However defined contribution account assets were invested (so long as widespread default did not occur), this approach would add revenue to the Social Security program by bringing a greater share of payroll into the system.

Whether financial solvency is maintained by levying taxes, curtailing expenditures, issuing debt, investing program funds in the private market, and/or mandating savings, it is necessary to specify the precise means of generating or saving program revenue in order to identify all possible implications. For example, if levying taxes or mandating savings is a means of generating program revenues, then the relevant questions are:

- Who pays these taxes or contributes to the individual savings accounts (e.g., the employer, employee, or others)?
- What would the rates be?
- What is the source of the money (e.g., expenditures on consumption goods, deductions from payroll earnings, taxes on retirement income earnings, etc.)?
- What groups would bear larger tax or additional savings contribution burdens, and which groups would be most affected by secondary effects from these changes?

If Social Security program expenditures are to be reduced, questions arise as to which expenditures and which groups would be affected. In the current debate, some expenditure cuts have been aimed at current and future retirees' benefits by adjusting the retirement benefit calculation.¹¹ Changes in normal (NRA) and early (ERA) retirement ages, in the retirement earnings test, in the

⁹ *If one of the investment options were a guaranteed investment contract (GIC), or a similar guaranteed investment like indexed Treasury bonds, technically the issuer would ultimately shoulder some of the investment risk, not the individual investor.*

¹⁰ *The National Thrift Plan proposed by the National Taxpayers' Union Foundation is an example of a defined contribution-style reform that would require the government to assist low-income workers in making contributions to their personal accounts.*

¹¹ *For example, the Maintenance of Benefits and Individual Accounts Reform Plans offered by the 1996 Social Security Advisory Council advocate using workers' best 38 years of earnings, instead of the currently used best 35 to determine benefits. Averaging in these additional three years will, on average, reduce lifetime benefits by 3 percent. See Kelly Olsen, "Keeping Track of Social Security Reform Proposals: A Summary," EBRI Notes (November 1996): 1–8.*

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number of working years taken into account in the Social Security benefit formula, in the consumer price index (which is the basis for cost-of-living (COLA) adjustments),¹² in spousal benefits,¹³ and efforts to de-link Social Security benefit levels from the rise in real wages have all been proposed.

If any portion of program funding is to come from the issuance of federal debt, the lenders must be identified in order to assess the implications for the rest of the economy. For example, sale of debt to overseas purchasers has different economic implications than domestically purchased debt. In addition, the persons who would bear the burden of paying back additional debt need to be identified, along with the extent of their burden as determined by interest rates, amortization period, and competing demands on their resources.

If private market investment is included in the reform, the next question is, who makes investment choices and who bears investment risks? If the government is to invest and assume any inherent risks, rules about investment procedure and composition must be established to guide the new reform and safeguard against possible abuses. Specifically, the following considerations would arise should the federal government become a major stockholder in the private U.S. market:

- In what percentage of the private market will the government become a stakeholder?
- If the government owns stock with voting shares, will it vote and, if so, how?
- Will the federal government voting its share

give the government “inappropriate” and/or “undesirable” control over the operation of the private market?

- If the government declines to vote its shares, then is it “problematic” that the remaining voting shareholders will have disproportionate influence?
- How will guidelines be established for government investment performance reporting timetables, and what will these guidelines be?
- How will the government choose investment funds, and will “social investing” occur, whereby the government chooses investment funds based on its charge to promote public well-being (e.g., not investing in a company known for Environmental Protection Act violations or in a company that produces a product the Surgeon General’s Office deems as detrimental to health)?
- Will investment be based on economically targeted investments (ETIs)? (Explained more fully on p. 26).
- Will the government simply try to index¹⁴ the stock market?
- How will market gains and losses be actuarially accounted for over time? Will the conservative rules applied to private pensions by the Internal Revenue Service and the Pension Benefit Guaranty Corporation be followed?¹⁵

If a reform is adopted that allows individuals to make their own investments in the private market, then, again, rules about investment

¹² All three Advisory Council proposals assume that the Bureau of Labor Statistics (BLS) will adjust the consumer price index (CPI), which is the basis on which Social Security benefits are indexed annually. In addition, the National Taxpayers Union Foundation’s National Thrift Plan and Kerrey-Simpson’s Strengthening Social Security Act of 1995 presume a CPI adjustment of -0.5 percentage points (*Ibid.*). The Boskin Commission’s Report to the Senate Finance Committee states that, “while the CPI is the best measure currently available, it is not a true cost-of-living index (this has been recognized by the Bureau of Labor Statistics for many years). Despite many important BLS updates and improvements in the CPI, changes in the CPI will overstate changes in the true cost of living for the next few years. The Commission’s best estimate of the size of the upward bias looking forward is 1.1 percentage points per year. The range of plausible values is 0.8 to 1.6 percentage points per

year.” See Michael J. Boskin et al., *Toward a More Accurate Measure of the Cost of Living: Final Report to the Senate Finance Committee from the Advisory Commission to Study The Consumer Price Index (December 4, 1996)*.

¹³ *Ibid.*

¹⁴ Index funds seek to mirror the performance of the stock market by investing in every stock in an index. Broadly based index funds are used to ensure adequate diversification. One of the most common is the S&P 500, which tracks the stock performance of 500 of the largest domestic corporations. However, an index could be more inclusive and include smaller companies (e.g., the Russell 3000 index). Other questions would necessarily arise during the implementation of this strategy. For example, should Social Security invest in nondomestic equities or investments other than equity securities?

procedure and composition must be established to guide the new program and to safeguard against possible abuses. In addition, if investments are held by individuals, issues of property ownership and control arise, such as:

- Are contributions mandatory or optional?
- Where can the individual keep his or her individual account (e.g., can accounts be held in the individual worker's bank or brokerage firm of choice or will they be maintained by the government)?
- Are individual accounts inheritable wealth?
- Can workers access their individual account funds for purposes other than retirement?
- Should the federal government be able to control investment options?
- Similarly, will workers be required to hold investments using a "life-cycle approach" whereby downside market risk is reduced as retirement age approaches by decreasing equity investment as age increases?
- Will workers be required to purchase or create life annuities at the time they retire, or will they be allowed to withdraw large lump-sum distributions?
- If annuitization is optional, what is the government's obligation to persons who exhaust their retirement funds prior to death?

Finally, a structure based on individual accounts may create new roles for the federal government. A defined contribution-style Social Security reform plan must specify the government's role in levying any new taxes, mediating investment risks, helping low-income workers make contributions, issuing or facilitating retirement annuities, and in meeting any other perceived needs arising from the new system's defined contribution component.

¹⁵ *If the government were to invest directly in equities, the combined OASDI trust funds' appearance of being funded over the short-term would vary because of variable returns from the private market. Currently, Special-Issue Treasury bonds provide fixed returns. However, the movement of Social Security defined benefit assets into investments with more volatile returns could subject the Social Security trust funds to the same type of conservative rules that apply in determining the funding status of private defined benefit plans.*

■ Comparing Outcomes

Attempting to forecast and compare outcomes of programs that have not been implemented is the most difficult step in making fair and comprehensive comparisons, as determining program outcome involves a myriad of sometimes very controversial assumptions. In addition, sometimes even ostensibly very small variations in expectations (e.g., one-quarter percentage point differences in annual growth, mortality, retirement, or interest rate assumptions) can, compounded over many years, result in vastly different policy outcome predictions.

Moreover, outcome anticipation is difficult because the basic assumptions and fundamental beliefs that go into the creation of different program goals reemerge as points of difference. For example, if one believes the economy works better the freer it is of government intervention, this belief might cloud one's prediction concerning a reform that adds to government regulation. Similarly, if one views the economy as working best only with increased government intervention, one might have negative predictions concerning a reform that reduces the government's role.

Although people's beliefs and assumptions differ, and therefore so will their policy outcome predictions, it is critical that they at least ask the same comprehensive analysis and comparison questions. Asking the same questions establishes a basic starting point for debate. In addition, if only a few considerations are used, both information required for identifying alternatives to current policy and the comparison will be incomplete.

For the purposes of Social Security debate, there are 11 broad policy outcome considerations: (1) adequacy, (2) equity, (3) monetary costs, (4) other economic effects, (5) effects on the rest of the U.S. retirement system, (6) governmental effects, (7) administrative effects, (8) political effects, (9) social effects (or, nonmonetary cost considerations), (10) protection against uncertainties, and, finally, (11) the determination of the best policy by weighing each of the aforementioned considerations. These outcomes must be identified in terms of three key aspects:

- each outcome's effect on all demographic groups possibly affected,
- potential short-term and long-term interactions

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among outcomes, and

- the rationale behind each outcome prediction.

The four points of consideration for outcome prediction rationale are: assumptions used, validity of assumptions, sensitivity of outcomes to assumptions, and robustness of these assumptions over time (i.e., the likelihood that the predicted outcome will persist). Clearly, sound outcome comparison and analysis defies cursory examination and is a multifaceted process, as further detailed below.

Adequacy

Adequacy measures the degree to which policy objectives are met in terms of benefit provision.¹⁶ In this context, adequacy determination is value neutral. In examining a Social Security system, vertical adequacy considers whether beneficiaries would receive the benefit levels indicated by plan goals. (Would actual benefit levels be as “high” as the policy’s goals?) Horizontal adequacy asks whether all persons targeted to receive benefits would actually receive them. (Would program coverage be as “wide” as the goals suggest?) For example, would some not receive benefits because they do not know they are eligible or because of administrative errors? Finally, subjective adequacy considerations ask whether enough beneficiaries would receive enough benefits (i.e., are policy X’s outcomes good public policy in terms of adequacy?).

A significant amount of discussion about adequacy has surrounded the current OASDI finance debate, as adequacy, in terms of a near poverty-level income base or floor of protection, is one of the Social Security program’s two primary goals.¹⁷ Because Social Security proposals using defined contribution accounts have been popular, potential risks involved in allowing individuals to assume more responsibility for their retirement

income security have raised concerns. Namely, the two primary risks are: (1) an individual’s likelihood of using a risk-averse investment strategy, causing his or her returns to be too low to yield an adequate retirement income base or floor and (2) the individual’s risk of selecting equities or corporate bonds that provide a lower than expected investment return experience.

To determine the likelihood that people will choose risk-averse investment strategies, expected investing behaviors on the part of individual workers have become a paramount adequacy concern. Questions about how to predict investment behaviors under a Social Security system that involves defined contribution accounts include:

- Which historic patterns of investment should be considered (e.g., is the recent past more illuminating about the future than the distant past? Should we look at investment behavior in all retirement plans, including those with both defined benefit and defined contribution components or just those with defined contribution-only plans)?¹⁸
- Would these patterns be likely to continue if a Social Security System with defined contribution accounts were adopted (e.g., would people invest more conservatively if they no longer had a Social Security defined benefit as a “safety net”? Conversely, would people become better at investment by necessity or because of the educational component of the new system?).
- Would the new system require a life-cycle investment approach (see below) to mitigate the possibility of “age inappropriate” investment choices?

Investment predictions tie into adequacy outcomes by asking:

- Are these predicted investment patterns likely to result in the level of retirement security

¹⁶ *Ibid.*

¹⁷ *The other primary goal of the OASDI program is equity. See Robert Myers, Social Security, Fourth edition (Philadelphia, PA: Pension Research Council and the University of Pennsylvania Press, 1993). Adequacy can have many definitions. Many analysts define adequacy as replacement of the preretirement lifestyle during retirement. Social Security seeks to provide this level of adequacy for very low-income retirees through a richer benefit formula than that which applies to others. At maximum wage base*

levels, adequacy is a life-sustaining benefit that is a small percentage of preretirement income.

¹⁸ *Some hypothesize that individual defined contribution account investment behavior on the part of workers with defined contribution and defined benefit plans is more aggressive than that of workers who expect to rely solely on defined contribution plans for their employer-based retirement income. The rationale is that the more dependent an individual is on a retirement plan, the less risk that individual is likely to take with the assets of that plan.*

- intended by plan advocates (vertical adequacy)?
- If not, how could investment behaviors be altered?
- If investment behaviors are to be altered through an educational effort, will there be enough resources to educate all groups and thereby ensure horizontal adequacy?

Concerns related to the risk of losing money in the equities market have led many advocates of defined contribution-style reforms to recommend that equity investment be restricted to broadly diversified funds comprised of stocks with historically strong performance records. If choices are thus limited, the possibility of adverse investment experiences becomes less of a concern than it would be if individuals were allowed to hold undiversified or highly speculative portfolios.

Some fear the risk of vertical inadequacy if retirees were forced to withdraw from their defined contribution accounts for living expenses or convert these defined contribution assets into annuities during a period of economic downturn. Most financial planners suggest that, with age, individuals should gradually convert investments in equities into investments with less volatile rates of return. This “life-cycle approach,” which averts a crisis whereby retirement funds must be pulled out of a down market, could be adopted by Social Security investors voluntarily or through a government mandate. Therefore, this particular risk of vertical inadequacy depends on use of life-cycle investment strategy, not only on the performance of the market at any point in time. However, because some individuals may choose a life-cycle investment approach and others may not if it were optional, questions of horizontal equity emerge (discussed in the next section).

Recall that adequacy, like every outcome

consideration, must be identified in terms of what demographic groups are most affected by programmatic adequacy lapses. In addition, it is important to understand how adequacy predictions were generated as well as what effect the adequacy level prediction may have on other considerations (e.g., political or social considerations or the burdens placed on other government programs).

Equity

Equity is the current OASDI program’s second primary goal (Meyers, 1993). Equity considerations involve identifying policy outcome “winners” (those who will or do receive disproportionate benefits) and “losers” (those who will or do bear disproportionate costs). Lifetime equity is often measured by ascertaining replacement rates, internal rates of return, and money’s worth ratios.¹⁹ Subjective equity considerations first include determination of whether programmatic distinctions made between beneficiaries’ level of benefits (e.g., eligibility requirements and redistributive components) are fair. The following questions emerge:

- Does the program reward certain behaviors, e.g., continuous work force participation, increased savings behavior, etc., with greater benefits, and are these criteria fair?
- Is the program redistributive and should it be? If so, how much?
- How much should spousal benefits provide?
- Are like beneficiaries treated alike, e.g., are there “notches?”²⁰ Are persons likely to receive different benefits solely as a result of investment “luck,” and is this an acceptable outcome provided that each beneficiary has equal investment opportunities?

A second equity consideration includes identification of the distinctions made between

¹⁹ Replacement rates are the ratio of benefits payable at age 65 or the onset of disability to pretax earnings in the prior year. Some analysts also define them as replacement of average lifetime earnings. Internal rates of return are the rates of return at which the present discounted value of future benefits is equal to the present discounted value of taxes paid. Money’s worth is the ratio measuring the present value of the benefits a typical individual has received or is expected to receive compared with the present value of the payroll taxes and other contributions that he or she has paid or is expected to pay, discounted at the actual past

and projected future rates of return on government bonds held by the Social Security trust funds. Advisory Council On Social Security, “Comparison of Plans,” Report of the 1994–96 Advisory Council on Social Security, Vol. I (Washington, DC, 1996).

²⁰ “Notches” refer to situations when younger workers with the same earnings records get lower real benefits than older workers. For an explanation of the notch issue, see Eric Kingson and Edward Berkowitz, Social Security: A Policy Primer (London, Auburn House: 1993).

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contributors' levels of burden. Are there disproportionate cost burdens imposed upon one group or age cohort? If so, are these distinctions fair?

Another equity question takes into account both costs and benefits: are rates of return fair across groups and/or age cohorts? Should employer contributions on behalf of workers be used in calculating individual rates of return?²¹ In addition, is it more important to consider whether participants have equal opportunity for receiving fair rates of return or to consider only the level of benefits actually received? Finally, equity, like every outcome consideration, must be identified in terms of which demographic groups are most affected by programmatic equity lapses. In addition, it is important to understand how equity predictions were generated and to consider what effect this prediction could have on other outcomes.

Program-Specific Monetary Cost Considerations

Comparing reforms involves projecting short-term and long-term program costs as a percentage of Gross Domestic Product (GDP), taxable payroll, and real dollar values in the following areas:

- one-time start-up costs,
- transition costs,
- operating costs,
- administrative costs,²² and
- borrowing costs.

Assuming cost predictions are valid, these costs must not only be averaged to ascertain actuarial balance over a given period of time; their distribution over time must also be identified. For

example, does the actuarial balance dip below zero at any time? If so, what are borrowing and tax rates predicted to be at that time? Is the average cost low but the distribution unstable in that sometimes costs are very low while at other times they are extraordinarily high? Finally, cost outcomes must be identified in terms of the demographic profiles of the people most likely to be affected in the immediate future and over time.

Cost estimates themselves are only credible if the assumptions and calculations used to derive them are valid. For this reason, it is crucial for fair comparisons to ascertain assumptions and data used, examine their validity, and assess the robustness of the results to changes in the assumption variables over time. It is also crucial to apply a sensitivity analysis²³ to determine cost estimates' sensitivity to changes in assumptions. One policy may have low costs only if certain variables remain constant and high costs if one variable changes. Another policy might not have the potential of reaching the low costs that the first policy is capable of reaching but may instead provide a more steady and predictable cost estimate because of its ability to maintain its cost rate within a range of economic scenarios.

Finally, cost outcome predictions must be viewed in relation to other outcome predictions in both the short and long term. For example, proponents argue that a higher cost Social Security policy that mandates individual private investment would only necessitate reduced consumption until the standard of living gains generated from increased availability of investment capital are realized, at which point consumption would rise higher than its current rate. On the other hand, some argue that the cost of a Social Security program with defined contribution accounts would initially decrease because of higher market returns,

²¹ *Individual assignment of employer contributions is not always the case in employment-based retirement plans.*

²² *Administrative costs are a particular concern for a system mandating individual savings accounts for all workers. Workers with very low earnings (e.g., teenagers with summer jobs, seasonal workers) might accumulate less in their individual accounts than these accounts would cost to administer and maintain. For this reason, some have proposed that very low wage earners should be exempted from mandatory savings contributions to individual accounts (see R.J. Myers, "Statement to the Subcommittee on Social Security of the Committee on Ways and Means, April 10, 1997").*

²³ *For example, there is a fair amount of disagreement with respect to the "best" assumption to use for improvement in future life expectancy. Sensitivity analysis on this variable would consist of running cost estimates under some baseline set of assumptions (perhaps those used in the Trustee's report) and then rerunning them assuming life expectancy actually increases faster (slower) than the baseline. The new cost estimates will be higher (lower) for each reform proposal, but the important point is whether the relative and absolute rankings of the alternatives vary as the life expectancy assumption is modified.*

but that costs would eventually increase while equity returns fall as the market adjusts to the new allocation of resources. (Such possible macroeconomic interactive effects will be explored more thoroughly in the next section.)

Extra-Programmatic Economic Considerations

Labor Force Participation—Pension systems, whether public and private, can encourage or discourage certain behaviors. In particular, the amount of benefit, the benefit accumulation rate prior to retirement age, the age at which benefits become available, and how future benefits change with continued labor force participation after retirement age affect workers' labor-leisure choices and savings-consumption choices. Therefore, an integral part of evaluating any retirement policy is the identification and examination of its intended and unintended effects on labor force behavior.

Many reform plans, as well as the changes in the current Social Security system already legislated, are structured to provide incentives to delay retirement. The accompanying argument is often that, although people today are living longer than they did in the 1930s when the Social Security retirement age was established, the NRA remains at age 65 for full benefits and at age 62 for early retirement.²⁴ While a gradual, two-year increase in the NRA was legislated in 1983, some advocate a more rapid increase to age 67 than that scheduled under current law and/or extending the NRA even further.²⁵ Nonetheless, many of these proposals' most ardent supporters recognize that raising the age for early and/or full retirement benefits is not without some controversial implications. Evaluation of policies to raise the early and/or full retirement age(s) includes the following considerations:

- Should public policy be concerned with when people retire, or should retirement age be viewed as a personal matter? If policy ought to attempt to influence retirement age, how do

proposals affect the following issues:

- How will a rise in the age at which Social Security retirement benefits become available affect workers with physically demanding occupations who will be less likely to be able to work in their occupations at later ages?
- If many laborers cannot work to the age of benefit eligibility, what is society's obligation to use resources to support these persons (e.g., by paying disability benefits), and to what extent will these costs offset the economic benefits of delayed retirement for the rest of the population?
- How will the private sector respond to increased labor force participation after age 62? Specifically, will private employers be allowed to raise the age of eligibility for private pension plans to correspond with the change in Social Security policy? If allowed, will they?
- Will age discrimination impede increased participation of older workers in the work force?
- Will there be enough jobs for older workers both numerically and in terms of appropriateness for the level of physical activity most persons over age 67 can perform?
- How will an increased number of older workers affect rates of unemployment, job opportunities, and career advancement for younger workers?
- If employers are expected to continue to employ aged workers, can they afford to do so at the pay increase schedules currently common in businesses, or will pay schedules designed to rise with seniority have to be curtailed and to what extent?

Savings—Unlike the current system, many Social Security reform plans are designed to increase workers' saving incentives and thereby lift net national saving. Many argue that an increase in net national saving will boost the capital available

²⁴ In 1935, average life expectancy at age 65 was about 77 for men and 78 for women. It has since increased to 80 for men and 84 for women (Advisory Council on Social Security, 1997).

²⁵ Two plans put forth by the 1994-1996 Social Security Advisory Council, the Individual Accounts and the Personal Security Account Plans, would increase the NRA more rapidly than current law,

resulting in an NRA of 67 for persons turning age 62 in 2011, as opposed to 2022 under current law. These reform plans would index the NRA to longevity thereafter, estimated to be about one month every two years. In addition, Kerrey-Simpson's Strengthening Social Security Act of 1995 proposes an NRA increase to age 70 by 2029. See Kelly Olsen, "Keeping Track of Social Security Reform Proposals: A Summary," EBRI Notes (November 1996): 1-8.

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for investment and therefore spur economic growth.²⁶ Increased voluntary savings incentives or a program of mandatory saving raises several questions:

- To what extent can the government affect net national saving, since an increase in one area of saving could be offset by a decrease in other areas of personal and governmental saving if overall consumption is not also reduced?
- How fast can the economy grow, and what is the ability of a national retirement system to increase growth rates?
- In a nation with many competing needs for resources, what is the appropriate priority level of increasing national saving, i.e., how much can America afford to save?
- How would individual and employer contributions to employment-based defined contribution plans be affected by higher Social Security tax rates and/or mandatory defined contribution saving plans?

Market Interactions—In addition to providing incentives to promote certain worker behaviors, a Social Security system exerts influence over the behavior of both government bond and private investment markets.²⁷ As indicated, many Social Security reforms have been specifically designed to promote saving so as to boost investment capital and thereby spur economic growth. However, some potential market effects may be unintended. Social Security policy's intended and unintended influence on the behavior of private investment and government bond markets is an (often highly technical) area of increasing interest among economists.

Social Security (OASDI) affects private markets because, with 141 million workers participating as of 1995 (and with several plans proposed to increase that number),²⁸ the program collects and allocates large sums of capital. In 1995, income of the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) programs was almost

\$400 billion, which included a \$59.7 billion surplus invested in Special-Issue Treasury bonds (Board of Trustees, 1996). By the end of 1996, OASDI program income was expected to have exceeded 5 percent of the nation's GDP, according to intermediate assumptions (Board of Trustees, 1996). Therefore, increased incentives through the Social Security program to save and/or to invest in private equities could prompt reallocation of significant capital and affect markets for this reason alone. Likewise, any changes in the amount of money handled by the Social Security program, the distribution of that money, or the investment thereof could also affect the behaviors of private and public markets.

The complexity with which changes in the OASDI program could affect markets is illustrated by consideration of the potential effects of the three Social Security Advisory Council proposals. All three proposals involve the reallocation of Social Security assets from Special-Issue Treasury bonds to private-sector investments in equities in order to take advantage of the higher rates of return currently available from the private equity market (Combs, 1996). Treasury bonds are projected to yield annual rates of return that exceed inflation by 2.3 percent, which appears low relative to equity return projections of about 7 percent over inflation (the same average as that over the past several decades) (Aaron, 1996; Social Security Advisory Board, 1996). Advocates of investing Social Security assets in equities expect the average return to continue to outperform rates on Special-Issue Treasury bonds.

An initial concern about investing Social Security funds in the private market is the ability of the private sector to absorb such large additional resources. Hence, one consideration for a Social Security system that would reallocate funding into private markets from other parts of the government or society is how quickly this transition would occur. Other concerns involve the expectation and

²⁶ For example, the National Taxpayer Union Foundation's Thrift Savings Plan, the Personal Security Plan and reforms advocated by Jose Pinera of the Cato Institute are designed to spur economic growth through increased private-sector investment. See Kelly Olsen, "Keeping Track of Social Security Reform Proposals: A Summary," EBRI Notes (November 1996): 1–8.

²⁷ The private investment market includes corporate bond and corporate equities.

²⁸ For example, all three Advisory Council plans would mandate that new local and state government employees be covered under the Social Security system. See Ann Combs, *Social Security: Options for Reform* (Washington, DC: William M. Mercer, Inc).

likelihood of equity returns remaining as high (or nearly as high) as they have averaged over the past several decades.

Depending on the reform plan, switching Social Security assets from Treasury bond investments to equities could mean less demand for Treasury bonds initially because the Treasury Department, a major purchaser, would no longer be buying as many of them, if any (e.g., assuming a balanced budget by 2002). To attract investors, the Treasury might need to increase its interest rates on government bonds.

If interest rates increase, some economic forecasters theorize that at least two forces could lower returns on equities. First, higher demand for equities might mean that equity prices could be bid up, causing their long-range rates of return to fall. In addition, higher interest rates might hinder business investment activities, which would be likely to cause the market value of equities to fall because of expectations of lower rates of return. Some argue that this effect could be mediated if international markets are large enough. In fact, no one knows precisely how the markets would respond to a shift of Social Security assets from Treasury bills to equities, because the economic effects of reallocating Social Security assets is a challenging area that scholars have just begun to address. However, given a reallocation of Social Security assets, the assumption that equity returns would remain at their current levels is not one to be taken without careful thought about market interactions.

Related considerations concerning the interconnected nature of markets include the following:

- If a new Social Security policy requires the government to repay part or all of the money it borrowed from the Social Security trust fund sooner than under current law, would taxes have to be raised sooner and more steeply?
- Similarly, if the federal government is prohibited from borrowing any additional revenue from the OASI and DI trust funds, can it be expected to reduce its annual budget deficit in response by raising taxes or reducing spending?
- If the government does not reduce its annual spending, will it borrow money from the private sector to replace the money it would otherwise borrow from the Social Security program?
- If the government borrows more money from the private sector, will interest rates rise on the

money that the government borrows in the future?

- If interest rates on government borrowings rise, will the interest on the federal debt rise and prompt an increase in income taxes?
- If income taxes rise as a result of a new Social Security policy that reallocates revenue into the private market, how much will the increased tax rates offset the benefits of the new policy?

Retirement Annuity Provisions²⁹—A Social Security reform with a defined contribution component could provide optional or mandatory annuitization. Like concerns that the equity market would be unable to absorb the flow of assets from a defined contribution-style Social Security policy, there are concerns about how quickly and adequately the private annuity market would be able to adjust to increased demand. In addition, there is some debate about the impact on annuity prices of optional annuitization. Some believe that increased demand would modify the adverse selection inherent in a voluntary annuity market and thus lower annuity prices, whereas others predict that the price of purchasing an annuity would ultimately remain the same.³⁰

Mandatory annuitization upon retirement raises the following equity considerations:

- In the past, the employee's gender was a factor in determining the annual retirement benefit that could be provided under a defined contribution plan. If a male and a female were the same age and had exactly the same amount accumulated under the plan, the male employee would receive a higher annual pension than the female employee. This was because the female employee was expected to live longer and, in anticipation of this, the same total amount was expected to be paid over a

²⁹ For a detailed explanation of different types of annuities, see Graves, 1994.

³⁰ Much of the debate focuses on load factors, particularly the portions represented by the cost of adverse selection. For an excellent historical study of the cost of adverse selection in the private annuity market, see Mark Warshawsky, "Private Annuity Markets in the United States: 1919–1984," *Journal of Risk and Insurance* (September 1988): 518–528.

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longer period of time. Because of the difference in life expectancies, the actuarial value of the pension, in both cases, was considered to be the same. In 1983, the Supreme Court ruled (in *Arizona Governing Committee v. Norris*) that life annuities under an employment-based defined contribution plan must be provided on a uniform basis.³¹

- Unlike the current Social Security system, annuities in the private market are not indexed. Because women tend to live longer, inflation has more time to erode their purchasing power in retirement, and therefore lack of indexation disproportionately affects women.
- While guaranteeing a spousal benefit if the beneficiary is married, the current Social Security system provides equal benefits to workers with the same covered earnings history regardless of marital status. The only way for a nonworking spouse to receive a benefit under a private market annuity is if a joint spousal annuity is purchased. Unlike the Social Security system, receiving a joint spousal annuity from the private market means that, in exchange for joint spousal benefits, the working spouse accepts a lower monthly annuity payment.
- Would joint spousal annuities be mandatory for individuals who qualify for Social Security benefits but whose spouses do not? If not, would this mean that nonworking spouses' retirement security would be left to the benevolence of their partners?
- If some nonworking spouses were not included in their partners' annuity contract, how much would society have to spend in terms of government programs to alleviate these spouses' potential poverty in old age? How much would this expense offset the advantages of the program?
- Could annuities issued by the Social Security Administration avert the above equity concerns? If so, how?

The foregoing questions highlight a difference in the fundamental objectives of the current Social

Security system and the current private annuity market system. In terms of providing guaranteed payments for life, the private annuity market emphasizes individual equity considerations that seek to equate individual contributions to expected individual benefits on an actuarial basis, leaving individuals with the responsibility of ensuring the adequacy of their own and their spouses' retirement income. In contrast, the Social Security system combines the goals of individual equity and social adequacy so that benefits are based on need as well as contributions (albeit indirectly) (Meyers, 1993). For example, if individual A paid twice the contributions as individual B and all other factors were the same (e.g., age and gender), A would expect to receive approximately twice the monthly benefits in a private annuity market system. Under the current Social Security system, A would expect to receive more than B (all things being equal); however, the benefit would be less than twice the amount B receives.

If annuities were not mandated and lump-sum distributions or any type of periodic payments from Social Security private accounts were permitted, individuals might desire to self-annuitize their savings in order to ensure a stream of income over the course of their retirement. Self-annuitization is a strategy that an individual can use to ensure that he or she does not outlive a particular amount of principal. This is accomplished by dividing the account balance each year by his or her life expectancy at that point in time and limiting the annual consumption to the amount determined by the calculation. This step is repeated each year, and the annual amount will vary from year to year as a result of investment income and changing life expectancies. The requirements involved in successful self-annuitization raise concerns about: (1) the willingness and ability of retirees to perform these annual calculations and to practice fiscal restraint, and (2) the fact that a certain percentage drop in the markets would yield a proportionate drop in annual consumption. As a result, the appropriate role of government or business paternalism is raised.

³¹ It should be noted that employees can buy annuities from insurance companies on the open market (i.e., apart from the qualified plan). At this time, insurers

do not offer such annuities on a unisex basis, although legislation that would require this has been proposed. Even though not required to do so, however, many insurers provide for unisex premiums.

Effects on the Rest of the U.S. Retirement System

The result of the Social Security debate could potentially have great impact on the design of the employment-based pension system. As mentioned earlier, an increase in the NRA and/or early retirement age would probably result in adjustments in employers' willingness to retain older employees and the designation of retirement ages for employment-based pension plans. (See the discussion under Labor Force Participation and Savings on pages 18 and 19.)

In 1993, nearly 48 percent of employees in medium and large private establishments were covered by defined benefit pension plans using benefit formulas that were integrated with Social Security provisions (U.S. Department of Labor, 1995).³² Hence, if Social Security benefit provisions change, the employers of approximately 7.7 million workers will most likely have to readjust their retirement plan formulas.³³ The total number of employers who would have to readjust is even higher, as the above figure does not include employees of small private firms who may also be participating in integrated pension plans. Readjusting benefit formulas for Social Security changes would entail an administrative burden in addition to any other potential burdens imposed on private pension sponsors under a new Social Security policy.

Some other considerations with respect to potential changes in Social Security policy on employment-based pension sponsors are the following:

- Would tax incentives for employment-based pensions—public and private—be reduced if Social Security costs put pressure on other parts of the federal budget?
- Would employees demand that employment-based pension plans be more generous under possible benefit cuts resulting from Social Security reform?
- Since employees who retire early sometimes receive bridge benefits from their employment-based pension plans until they become eligible for Social Security, would an increase in the NRA raise bridge costs and reduce bridge benefits as a result?
- How much in resources can employment-based pension sponsors be expected to allocate in adjusting to new Social Security policy in a time when they, too, will need to prepare and provide for demographic pressures on their own plans?
- If part or all of Social Security's current defined benefit system were reformed to include defined contribution accounts, would workers feel uneasy about not having as much of a defined benefit guarantee in retirement and therefore pressure employers to expand employment-based defined benefit plans in terms of benefits and sponsorship? Would employers be encouraged to abandon employment-based defined contribution plans?
- If Social Security policy is changed to encourage more delayed retirement, will employer health care costs rise as a result of an older

³² *Integration with Social Security can be done in several ways, but the basic purpose of integration is to allow employers to take credit for the fact that they are financing one-half of the payroll tax assessed for the Social Security retirement benefits for their employees. In certain defined contribution plans, employers are allowed to contribute a fixed percentage of compensation for all parts up to a specified level of compensation and then a larger percentage for compensation in excess of that amount (up to the 401(a)(17) limit). The permitted disparity between the two percentages is controlled by Internal Revenue Code sec. 401(l).*

Integrating a defined benefit plan with Social Security is a more complicated procedure; however, the employer is allowed to indirectly increase the generosity of the benefit provisions for employees earning in excess of the maximum taxable wage base (\$62,700 in 1996) in recognition of the fact that no Social Security

retirement payroll tax has been paid by the employer on these wages.

*For a complete explanation of integration provisions, see Chapter 8 (for defined contribution plans) and Chapter 14 (for defined benefit plans) of Everett T. et al., *Pension Planning, Seventh edition* (Homewood, IL: Irwin, 1992). Also see *Employee Benefit Research Institute, Fundamentals of Employee Benefits, Fifth edition* (Washington, DC: Employee Benefit Research Institute, 1997) and James Schulz and Thomas Leavitt, *Pension Integration: Concepts, Issues and Proposals* (Washington, DC: Employee Benefit Research Institute, 1983).*

³³ *EBRI tabulation from the U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1993* (Washington, DC: U.S. Government Printing Office, 1995).

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work force? If so, will this reduce the funds available for employment-based pension plans?

Not only is there concern as to the extent employers sponsoring pensions will adjust to changes in Social Security policy, but there is also debate as to how workers participating in employment-based plans will alter their behavior and how these adjustments will affect their retirement security.

- If private investment accounts are incorporated into Social Security, would workers, upon seeing large accumulations in their Social Security accounts, be less likely to invest in employment-based plans?
- If so, will this negatively impact retirement security, or will the accumulations in Social Security accounts be enough to sustain secure retirement?
- If the new Social Security program has a defined contribution component with educational efforts, will this increase workers' awareness of the necessity and benefits of saving as well as the potential effects of inflation and thereby increase worker participation in employment-based pension plans?
- If the reformed Social Security system provides lower expected benefits than today, will workers realize the need to increase savings in their defined contribution employment-based plans to the extent permitted by the employer?

Ultimately, changes in the Social Security system could impact all legs of the retirement income stool,³⁴ potentially changing its very constitution.

Governmental Effects

The Social Security OASDI program is not the only government program that promotes retirement security. For example, Medicare Part A and Part B assist in covering the costs of acute inpatient care and short-term rehabilitation as well as physicians'

visits and outpatient procedures; Medicaid pays for long-term care services for the impoverished elderly; the Supplemental Security Income (SSI) program and food stamps program assist poor elders in meeting basic living expenses; and the office of Housing and Urban Development (HUD) sponsors low-income housing programs for seniors.

Because the OASDI program is but one part (albeit a large one) of the entire U.S. system to prevent poverty in old age, the effects of the current system or a new Social Security policy on the nature of the nation's entire system of old-age assistance policy must be considered.

- What effects will Social Security reform have on the Medicare program, which is facing more immediate insolvency projections and higher predicted cost growth?
- To what extent do potential cuts in Social Security benefits simply force cost shifting onto other programs that target the elderly? If cost shifting occurs, to what extent, if any, does the program stigmatize beneficiaries by either directly means-testing Social Security or by making more elders dependent on other means-tested programs?
- To what extent does the maintenance of current levels of Social Security benefits detract from the amount of money available to other government programs related to the elderly?
- To what extent does the redistributive generosity of the Social Security program discourage work and savings, thereby promoting dependence on government programs in retirement?

Just as the Social Security program is only one part of the federal government's efforts to secure retirement, these programs to benefit the elderly are but one part of the entire U.S. federal government's operations. Considerations related to other government functions include the effect of Social Security costs and benefits on:

- other parts of the OASDI program that do not directly target the aged (For example, will Disability Insurance (DI) be separated from the rest of the system under a new reform? Will old-age and survivors benefits be separated from survivors' benefits for younger spouses and dependents? How will an increase or decrease in the generosity of one OASDI program affect the resources and efficiency of

³⁴ *The retirement income stool has traditionally been defined as having three legs: Social Security, individual savings, and private pension income. EBRI publications, beginning in 1979, have suggested that there are more "pillars," including wages from work, government assistance, survivor benefits, inheritances, long-term care insurance, etc.*

- another?);
- total public spending as a percentage of GDP;
- federal deficit burdens;
- resources available for other government programs such as environmental protection, welfare to children, defense, public health, highways, education, and national security (opportunity costs from allocating resources to the Social Security program that could have gone to other programs);
- amount of federal tax revenues collectible from the private sector; and
- confidence in the federal government and in the Social Security program.

Administrative Considerations

Administrative costs are not the only administrative considerations that must be factored into policy comparison and evaluation. While related to cost, complexity of administration is a consideration in its own right, as increased complexity can lead to decreased program efficiency and thus to decreased political support. In order to assess administrative complexity, one must determine the point of equilibrium whereby a program is complex enough to meet the needs of a nation of different individuals in various circumstances yet straightforward enough to run efficiently. It is difficult to discern the appropriate levels of complexity for the combined OASDI program, which covered 141 million workers and 43.4 million beneficiaries in 1995 (Board of Trustees, 1996) and whose coverage is continually growing.

Administrative considerations include estimates of how often the policy will require regulatory changes and of the policy's flexibility adapting to the nation's ever-changing social, economic, and regulatory environments. Similarly, comparison and evaluation require the prediction of how regulation will evolve. An initially simple policy can become a tangle of regulations over time under political pressures. Finally, administrative considerations include identifying the office that wields administrative power, evaluating the office's past performance, and predicting its future behavior.

Political Considerations

Many political considerations involve the political feasibility of passing and regulating a policy. For example, today's Social Security debate includes

various opinions about how willing Congress would be to mandate increased OASDI contributions if such contributions were not "taxes" but "mandatory savings contributions" instead. In addition, reservations about regulatory feasibility are reflected in concerns about administrative burdens and complexity.

Political risk issues seem to have dominated political considerations, however. Political risk is the likelihood that a program or policy will lose its political support or that policymakers will make changes that prevent stated policy objectives from being realized. The political risk inherent in the current system is evident in surveys that have found high support levels for Social Security among younger workers but low levels of confidence that they would receive full benefits from the current system.³⁵ In addition, younger generations have lower expected rates of return on OASDI contributions. As a result, some reform proponents believe that younger workers may provide less future support for the program.

Another political risk is that policymakers might wait so long to reform the current system that the changes needed for balance would be extreme, rather than limited, and cause political upheaval. A further risk relates to what might happen with a system of defined contribution accounts were individuals to invest in the stock market. If a market drop were to occur (especially if it happened right before a significant number of persons planned to retire), would the public demand restitution or a policy reversal?

A political risk concerning the use of defined contribution OASDI accounts to augment a base defined benefit program is the possibility of declining political support for the defined benefit part of such a "two-tier" system. Social Security's

³⁵ See *Employee Benefit Research Institute, Mathew Greenwald and Associates, and the American Savings Education Council, 1996 Retirement Confidence Survey (Washington, DC: Employee Benefit Research Institute, 1996); Employee Benefit Research Institute / The Gallup Organization, Inc., "Public Attitudes on Social Security, 1995," EBRI Report G-62 (Washington, DC: Employee Benefit Research Institute, 1995); and Virginia Reno and Robert Friedland, "Strong Support but Low Confidence: What Explains the Contradiction?" in Eric Kingson and James Schulz eds., Social Security in the 21st Century (New York: Oxford University Press, 1997).*

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equity goal most favors middle and high income participants, whereas its adequacy goal most favors workers with lower incomes. Lower income workers tend to have a higher percentage of their preretirement incomes replaced by Social Security, but those with higher incomes tend to receive higher absolute benefits. A two-tiered system would make explicit which benefits originate from the program's equity goal (via the defined contribution account, which would reflect contributions and would thereby most favor middle and high income workers, who have the most to contribute) and which benefits originate from the adequacy goal (via the defined benefit account, which would reflect entitlement and/or need, possibly most favoring lower income workers). Would higher and middle income workers withdraw support from the adequacy (defined benefit) tier and press for the expansion of the equity (defined contribution) tier, preventing a two-tiered program's adequacy goals from realization?

Additional potential risk involved in the private investment of Social Security funds, either by individuals or the government, are issues of economically targeted investments (ETIs) and corporate governance. Under a system of individual accounts, unless workers were 100 percent free to invest however they choose, the government might establish the range of "appropriate" investment options available and any requirements for life-cycle investment. Among the considerations are:

- Would criteria for selection of domestic and international investment options for workers be based on social considerations such as a company or industry's compliance with Environmental Protection Act standards or a nation's human rights practices?
- Would options be based on consistent returns history, such as on the basis of whether a company's stock were "blue-chip," or would ETI options be mandated?
- If investment options were selected on the basis of "blue-chip-type" standards or ETIs, would this unfairly discriminate against other enterprises?

The government might exert more influence on investment choices if it directly invested trust funds in the private market itself, unless investment is in index funds. Concerns are also raised

about real or imagined scandals between the government and businesses that are vying for selection as a Social Security investment option or as part of the index in which Social Security invests. Such controversy could erode political support for the program and thereby expose defined contribution-style Social Security plans to political risk.

In addition, unless regulation of individual investment brokers is adequate, some fear market "scams" could emerge, which would undermine support for a system using defined contribution accounts. Others suggest that regulation of public pension funds, such as the Federal Thrift Plan for federal government employees, shows that the necessary regulation and enforcement bodies are in place to ensure that such quagmires can be averted. However, this still leaves some concerned about corporate governance issues should the government own large blocks of stock in public corporations.

A final risk relates to defined contribution account balances. Would policymakers decide to allow preretirement access to funds under the pressure of other goals, as they have with individual retirement accounts (IRAs) and 401(k)s? And, if they did, what would be the retirement income implications? Should people be allowed access to their accounts (through loans or early distributions) prior to retirement age for certain circumstances or emergencies such as financing education, starting a business, paying medical bills, or avoiding bankruptcy? If yes, which circumstances would be appropriate for early withdrawal or loans? Would early withdrawal or loans involve a penalty? If Social Security account balance holders were unable to make their mortgage payments because of preretirement withdrawal or loan restrictions, would they demand that the system be changed? The history of access rules for private pensions and IRAs suggests that this issue would be regularly revisited.

Some oppose preretirement access to defined contribution-style Social Security accounts, arguing it would undermine the system's political stability by eroding its financial stability, since preretirement use of funds would affect the adequacy of postretirement benefits. Others support preretirement access in situations where a person would otherwise need government support on the

grounds that, ultimately, preretirement access for these individuals would have no net effect on government expenditures. If such persons could withdraw from their Social Security accounts in their preretirement years, the government may need to support them during their old age; if such persons were denied preretirement access, the government may have to support them until old age. Those not opposed to preretirement access argue that, either way, the government pays and Social Security account accumulations are used.

Social Considerations

Social considerations involve the identification of costs and benefits that do not have a quantifiable, objective monetary value but are nonetheless crucial to factor into the comparison and evaluation of Social Security policy. Social considerations that have been identified include:

- Are people informed about the financial protection and risks involved in the program? (Some, for example, have raised the question of whether defined contribution-style programs could ever adequately inform younger workers of financial risks, since younger workers have lived in an era of relatively constant high returns from equities, where risk existed but was not realized on aggregate.)
- Does the program promote financial literacy among participants?
- Does the program provide a sense of national community and cooperation?
- Does the program contribute to peace of mind in regard to the adequacy of aged family members' incomes and in one's own retirement security?
- Does the program help mediate the burdens of younger family members in caring for and financially supporting their aged?
- Is the program's public discourse honest? (For example, are tax increases and benefit cuts presented straightforwardly to the American public, or are they hidden behind more politically palatable rationales?)
- Are Social Security costs being shifted to other programs without this being understood by the American public? Does the program make excessive promises?

Because of different fundamental beliefs about the appropriate nature of a Social Security

system, one may find all, some, or none of the above social considerations appropriate to ask of Social Security policy. What social considerations are considered germane depends significantly on the subjective value framework and fundamental beliefs taken into account in determining appropriate OASDI policy goals.

Protection Against Uncertainties

Related to the foregoing social consideration of peace of mind, a Social Security program's ability to protect against uncertainties, or risk, means that at least one part of individuals' and households' retirement security cannot be eliminated by shocks in earnings or expenditure needs such as disability, unemployment, unforeseen longevity, or unexpected inflationary growth (Boskin et al., 1996). The current system protects against inflation and unexpected longevity by indexing and annuitizing benefits. Furthermore, the current system attempts to protect all aged and/or dependent married persons from the risk of losing support because of a spouse's death by providing survivors' benefits under the retirement program. Finally, the current OASDI system mitigates the effects of shocks to earnings from disability by providing disability insurance.

Trade-offs occur in a system that attempts to mitigate uncertainties. The primary trade-off is the lack of individual control that results from participation in a program that pools risk. This means that some beneficiaries will receive less than they would have if they had controlled their own money and not participated in the program; others, who experience misfortune such as disability, widowhood, or unexpected longevity, will do better than they would have done on their own.

An underlying premise of many Social Security reform advocates is that the risk-pooling nature of social insurance programs actually increases the likelihood of risk occurrence. They argue that if individuals know that risks leading to poverty in retirement—such as unforeseen longevity, inflation, and disability—are guaranteed to be allayed should they occur, they will not do everything in their power to prepare for these risks. There is a wide range of opinions concerning which and to what extent risks and uncertainties are controllable and the appropriate treatment of people who take advantage of the risk-mediating

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nature of the current system by insufficient preparation. Hence, evaluation and comparison require a conception of what level and type of risk protections should be part of Social Security policy and consideration of whether a given policy actually meets that standard.

Weighing Considerations to Determine the Best Social Security Policy

This final consideration recognizes the variation in subjective weights that different persons place on the 10 other areas of consideration. For example, some may believe that social considerations are less important than economic considerations, or vice-versa. Some place higher value on achieving adequacy in a Social Security program, whereas others find equity a more compelling consideration. Some believe equity means redistribution, but others believe it means proportionate returns. These value differentials determine how people weigh the importance of the above 10 considerations and thereby synthesize a large amount of information into one decision about which Social Security policy is “best.”

Conclusion

Just as this evaluation and comparison framework began with considering the impact that policy advocates’ subjective value bases and beliefs have on plan goals, it ends with similar subjective considerations of policy evaluators’ weightings of different areas of outcome consideration. Hence, the framework emphasizes the role of fundamental beliefs and values in the Social Security policy debate, highlighting the risk that discourse among different parties may take place on entirely different philosophical planes. However, the Social Security debate is not solely a subjective one; this framework has presented some of the numerous and interrelated technical, economic, political, and administrative questions that need to be addressed in the process of fair and complete analysis and comparison.

The framework also shows that people with the same value beliefs can arrive at different policy outcome predictions, whereas people with the same policy outcome predictions can arrive at entirely different valuations of Social Security policy options. The interplay between complex beliefs and

values is testimony to the potential shortcomings of any proposed “easy answers” to the resolution of Social Security’s finance issues. As this framework shows, in fair and comprehensive comparison and analysis, every Social Security policy reform, as well as the current system, must be held accountable to a number of hard questions.

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Economic Security: An Overview of Social Security

by David V. Bryce and Robert B. Friedland

■ Introduction

Social Security is the nation's largest and most successful public program. It has affected the way we view retirement and enabled generations of elderly to leave the labor force and remain financially independent. Even though most people have little confidence in the future of the program, it has and continues to be very popular (Friedland, 1994; Reno and Friedland, 1997). In 1995, an estimated 141 million workers participated in the Social Security system, and 43.4 million people, or 17 percent of the population, received benefits from it. Most recipients were retirees (62 percent), but 9 percent were disabled workers, and 29 percent were surviving dependents, including 2.3 million children.

The passage of Social Security not only changed people's lives, it changed our views about the role of government and about retirement. However, this debate is not over. In fact, since the days of the earliest pilgrims, we have been sorting out the boundaries between private and public concerns (Achenbaum, 1987). The public policy debates over Social Security were certainly consistent with this all-American struggle. Whether the program should be mandatory or voluntary; federal or state; its impact on the private sector; and individual responsibility were all issues in the debates. Our responses to these issues reflect our societal values. These questions must be continually asked in light of changing demographics, economics, and expectations.

During the 104th Congress, the debate over individual responsibility and government accelerated. However, Social Security was left out of the debate. Social Security is not likely to remain "off the table" forever. At the very least, the Social Security Trustees will remind us that the combined Old-Age, Survivors, and Disability Income (OASDI) Trust Funds will not be solvent beyond 2029.

Furthermore, Social Security is 22 percent of the federal budget and will be growing. More importantly, the 1995 Social Security Advisory Council's recently released recommendations for ensuring solvency to 2070 are sparking interest in reform. This debate is reminiscent of the debate surrounding the initial passage of the Social Security Act in 1935. This discussion reviews the past in light of today's issues.

■ Enacting the Social Security Act of 1935

On August 14, 1935, approximately one year after he had charged the Committee on Economic Security with the task of developing a government program capable of protecting Americans "against the hazards and vicissitudes of life," President Franklin D. Roosevelt signed the Social Security Act into law. The act's foremost provisions established a compulsory old-age insurance program, an unemployment compensation program, and a federal-state matching fund program for assistance to the aged, the blind, and the fatherless. The legislation was a watershed event in American history, enacting the first truly national public benefits program—and correspondingly establishing the federal government as a major player in the area of social welfare—and providing a policy blueprint to which subsequent public benefit programs would largely adhere.

The act's passage is especially significant when considered in light of America's historical aversion to government initiatives. From its birth, the United States has generally maintained allegiance to the Jeffersonian credo, "That government is best which governs least." This is particularly true in the case of public benefit programs, which did not gain political legitimacy until the Great Depression. Prior to that, political move

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ments in the United States tended to concentrate on reforming the democratic *process*—for instance, expanding the right to vote or achieving direct primaries—and rarely viewed the government as a potential contributor to material security. So deep was the aversion to public benefits that even major labor unions opposed such programs, fearing that they would wean workers away from union loyalty and toward government dependence. Thus by the 1920s, when each country in Western Europe had instituted national benefit programs, public benefits in the United States consisted primarily of local poor relief.

America's lack of interest in social welfare was predicated on the popularly held belief that, through individual industriousness, all persons were capable of becoming self-reliant. In accord with this view, the prospect of destitution was considered a key ingredient in motivating individuals to maximize their productivity. Many feared that if the government alleviated the prospect of destitution by instituting benefit programs, individual incentives to work would decrease, thus jeopardizing the economic and moral health of the nation. As Frederick L. Hoffman, an executive with Prudential Life Insurance in the early 1900s, stated in summarizing his opposition to public retirement provisions, "pensions will undermine... the self-respecting character of our people as citizens in a democracy where economic independence, achieved by individual effort, self-sacrifice, and self-denial, is, after all, the only aim and end worth while" (Lubove, 1968). In the late 19th and early 20th centuries, it was generally presumed that the poor were solely responsible for their predicament.

However, despite this philosophical conviction, a variety of arrangements were designed to alleviate economic suffering. Many of these were relief programs operated by voluntary associations or charities. Individual families were also a frequent source of support for aged relatives. In fact, many communities mandated that such support be given, passing laws that punished family members who failed to provide for their elderly parents.

In addition to associations, charities, and families, some individuals received support from private benefit programs offered by their employer. These were generally designed to assist retirees or the dependent family members of workers killed in

job-related accidents. In the early 20th century, and particularly following the First World War, when Americans witnessed the "dole" rapidly spreading through war-ravaged Europe, company benefit programs were heralded for their ability to protect workers from the hazards of an industrial economy, while simultaneously promoting the individual work ethic. Pointing to the situation in Europe, advocates of company programs noted that private sector welfare provisions were far less likely to fall prey to political pressures calling for liberal benefit expansion. Yet, while scholars debate the motives behind private pensions, they agree that these programs were inadequate, despite their proponents' claims.

In a study conducted in the 1930s, Murray W. Latimer estimated that no more than 14 percent of the labor force was covered by such a program (Latimer, 1932). Furthermore, many people who were covered failed to receive benefits. According to Latimer, two-thirds of all noncontributory private pension plans in 1932 contained disclaimers stating that workers who had fulfilled their service and conduct requirements had no "right" to benefits. Consequently, in 1932, in a population of persons aged 65 and over totaling 6.5 million, less than 2.5 percent received income from a private pension.

Although Americans were disinclined to look on government as a source of material relief, some publicly administered old-age pensions did exist prior to the Depression. Most prominent was the Civil War Pension Program (CWPP), which by 1894 accounted for 37 percent of the total federal budget. Funded by general revenues, the CWPP expanded rapidly in the years following the Civil War, often being used as a source of patronage to lure prospective voters. This experience, combined with excessive corruption within the program, has led some historians to argue that the CWPP's susceptibility to political pressure for expansion played a role in convincing the architects of the Social Security Act that benefit programs funded through general revenues were neither financially viable nor politically wise.

There was also a variety of state run benefit programs. The majority were noncontributory old-age pension programs that empowered county officials to determine whether benefits would be provided within their jurisdiction. Most frequently, they were not, and in 1928 only about 1,000 elderly

persons were receiving state pensions. Moreover, a number of state operated pensions were deemed unconstitutional. In 1928, the Supreme Court outlawed programs in Montana, Nevada, Pennsylvania, and Oregon. At the time, it was well established in the law that taxation could be imposed only for “general” purposes. In the court’s view, public pension programs violated this principle because they raised taxes specifically to finance “individual” benefits.¹

The Impact of the Great Depression

The Great Depression abruptly shattered the view that the only impediment to economic security was hard work. Between 1929 and 1932, the commonprice stock index plummeted, and real Gross National Produce (GNP), which had increased by 22 percent between 1923 and 1929, dropped 30.4 percent. Five thousand banks, with

assets totaling \$3.2 billion, became insolvent; 90,000 businesses failed; and aggregate wages fell to 57.4 percent of their 1929 value. As unemployment increased from 3 percent to over 25 percent, people became progressively aware that individual effort provided no guarantee of material security, and they began increasingly to seek government assistance. This shift in public opinion culminated in the presidential election of 1932, when Herbert Hoover, vowing to continue “private efforts,” was resoundingly defeated by Franklin D. Roosevelt, a candidate who pledged government initiative and innovative solutions.

While the Depression laid bare the economic instability of numerous social groups, it was particularly uncompromising to the elderly. Between 1929 and 1932, 45 private pension plans covering over 100,000 workers ceased to exist. Private charities and relief agencies were swamped

¹ *These rulings, and the precedent on which they were based, greatly affected the drafting and content of the Social Security Act. The Supreme Court in the 1930s possessed a decidedly negative opinion of government legislation pertaining to social or economic issues. However, although fear that that act would be struck down led to Roosevelt’s infamous attempt to “stack” the court, members of the Committee on Economic Security were aware of at least two rulings that augured well for public benefit programs. In the first, Frothingham v. Mellon, the court established the constitutionality of federal grants in aid for the purposes of social provision. In the second, Florida v. Mellon, the court upheld a tax offset credit device contained in the Revenue Act of 1926. Awareness that the court accepted these practices as constitutional influenced the Social Security Act, particularly the components establishing old-age assistance and unemployment compensation. Both of these programs were financed through federal grants in aid, and unemployment insurance contained a considerable tax offset device intended to encourage employers to contribute to unemployment funds. However, neither of these rulings provided a window of opportunity for old-age insurance, a program that was to be the federal government’s exclusive domain and was fully financed by payroll taxes. As a result, fears persisted that the court would interpret the payroll tax as one intended to provide for “individual” rather than “general” welfare and thus void the act.*

Several steps were taken to minimize the likelihood of this occurring. First, to de-emphasize the connection between benefits and taxes, the act was careful to detail these provisions under separate titles. Second, the act made no mention of directly relating benefits to contributory taxes and did not directly stipulate that the proceeds to the tax be placed in an

old-age reserve account. Finally, although proponents believed that the key to popularizing the act was equating contributions with benefits, thus creating a perception that individuals were contributing to their own retirement account, they were careful not to promote Social Security in this manner until after the Supreme Court had ruled on its constitutionality.

In 1937, the court handed down two rulings establishing the constitutionality of the Social Security Act. The first, Steward Machine Co. v. Davis, validated the unemployment insurance tax required of employers of eight or more employees. In brief, the court ruled that the tax was legitimate because it was being used to promote the general welfare. According to the opinion, written by Justice Cardozo, “It is too late today for the argument to be heard with tolerance that in a crisis so extreme the use of the moneys of the nation to relieve the unemployed and their dependents is a use for any purpose narrower than the promotion of the general welfare.” In the second case, Helvering v. Davis, the court upheld the use of payroll taxes for the provision of old-age benefits. This opinion, again read by Justice Cardozo, argued that the “general welfare” had been altered by industrialization in a manner that adversely affected the elderly. According to Cardozo, “More and more our population is becoming urban and industrial instead of rural and agricultural. The evidence is impressive that among industrial workers the younger men and women are preferred over the older. In time of retrenchment, the older are commonly the first to go, and even if retained their wages are likely to be lowered.” In the court’s opinion, the consequences of this trend were “national in area and dimensions,” and hence a federal program of old-age benefits was ruled to be in the interest of the nation’s “general welfare.”

beyond capacity and forced to turn away thousands of needy seniors. According to economist and future Senator Paul H. Douglas, these circumstances “convinced the majority of the American people that individuals could not themselves provide adequately for their old age and that some sort of greater security should be provided by society” (Achenbaum, 1987). In the early 1930s, this popular realization was increasingly channeled into social movements that called for the implementation of government pensions.

The Influence of the Townsend Movement

Although historians debate the relationship of various social movements to the passage of the Social Security Act, they generally agree that the Townsend Movement was integral to the inclusion of old-age insurance. Townsend, a doctor from California, proposed providing each person over age 60 with a monthly check for \$200, stipulating only that recipients be retired and spend the entire sum within 30 days. Two hundred dollars a month was a fantastic amount, especially considering that workers in 1932 took home average monthly checks of \$95. Yet in Townsend’s view, which mimicked a prevalent economic theory of the time, the economy could only be rejuvenated through consumption. Providing this amount of monthly income would spur the economy by initiating consumption.

Townsend proposed to finance his plan through a 2 percent transaction tax on business, and despite the unfavorable response he received from both the academic and business community, he rapidly accumulated a base of staunch supporters. By 1935, his movement had 3.5 million dues-paying members, a club in every congressional district, and had submitted a petition to Congress signed by 20 million people who urged the passage of a “Townsend Act.”

Legislators were clearly aware of public support for the Townsend Plan. According to Robert Doughton (D-NC), who chaired the House Ways and Means Committee, the American system itself was in jeopardy: “The presence of insecurity on such a vast scale is a serious threat to our economic order...the fact that several of these proposals have attracted a widespread following implies a threat to our existing institutions which should not be regarded lightly.” Similarly, Congressman James Mott (R-OR) asked of his fellow legislators, “Is this

body, the duly constituted representatives of the people, going to completely deny their petitions?”

Such rhetoric convinced President Roosevelt that radical measures like the Townsend Plan—which his advisors informed him was financially impossible and was in any case considered by the President to be incompatible with America’s proclivity for individual effort and reward due to its reliance on a flat benefit structure—were not necessarily political long shots. This concerned Roosevelt, who was willing to experiment with using government to speed recovery but feared that Congress might push him “in a direction far more radical than any he had originally contemplated” (Leuchtenberg, 1963). Furthermore, Roosevelt himself was sensitive to a growing public desire for some form of government benefits.

To avoid this, the president took the initiative in designing a government benefit program that would be sustainable, in accordance with his political views, and capable of alleviating the economic insecurity gripping America. Thus on June 8, 1934, he addressed the nation, stating that the foremost objective of recovery was “the security of men, women, and children” (Witte, 1963). Roosevelt defined “security” as consisting of three factors: a decent home to live in, the development of the nation’s natural resources in a fashion that would maximize employment opportunities, and protection against “the hazards and vicissitudes of life.” Regarding this latter concern, Roosevelt promised to establish a committee to formulate a proposal for submission to Congress at the beginning of its next session. This became the Committee on Economic Security (CES).

■ The Approach of the Committee on Economic Security

The CES—headed by Secretary of Labor Frances Perkins, who chose Professor Edwin Witte from the University of Wisconsin to serve as staff director—was charged with developing a workable social insurance system. Any group then facing such a challenge could draw on two distinct approaches to public benefits, both named after states that had implemented programs based on the respective philosophies. The Wisconsin Plan stressed prevention of economic insecurity, while the Ohio Plan emphasized providing adequate benefits to those in

need. Thus the Ohio Plan recommended that the goal of benefit programs was to provide a “living wage” to those in need, for instance, the unemployed or retirees. Conversely, benefits in the Wisconsin Plan were not predicated on a direct response to economic need but rather were intended to mitigate the impact of particular occurrences such as the loss of income due to retirement or disability. Furthermore, the Wisconsin approach attempted to minimize interference with market forces by linking retirement benefits to an individual’s employment and wage history. In essence, the Wisconsin Plan provided a floor of protection in the event of certain occurrences while otherwise remaining as faithful as possible to the American spirit of individual effort and reward.

Roosevelt clearly favored the Wisconsin Plan, believing the Ohio approach too closely paralleled the public assistance programs proliferating in Europe and would ultimately lead to dependency on “the dole.” When introducing to Congress the legislation that would become Social Security, Roosevelt stated, “The lessons of history, confirmed by the evidence before me, show conclusively that continued dependence upon relief induces a spiritual and moral disintegration fundamentally destructive to the national fiber. To dole out relief in this way is to administer a narcotic, a subtle destroyer of the human spirit. It is inimical to the dictates of sound policy. It is in violation of the traditions of America” (Schiltz, 1970). Thus Roosevelt sought a benefit system that would be distinct in both practice and public opinion from “relief” or “welfare,” based on his belief that the key to avoiding such stigmas was the development of a program that attained its social legitimacy from the achievements of beneficiaries. As a result, Roosevelt overwhelmingly selected advocates of the Wisconsin Plan to head the CES, preconditioning the committee’s final report, which was presented to the him in early January 1935.

Fulfilling Roosevelt’s wishes, the report was quickly transformed into legislative language and submitted to Congress. Surprisingly, considering the magnitude of the bill, it met with relatively little congressional opposition and was not dramatically altered from its original form prior to passage. Legislators who did oppose the bill were those who generally rejected any form of government benefit programs.

One of the most outspoken critics was Rep. Charles Eaton (R-NJ), who summarized his opposition stating, “I think we stand today in this country at the crossroads of a great decision which transcends all parties, all sections, and all interests; and this decision is whether we are going to choose American industry as the instrument for the solution of these tremendous far reaching problems, or whether we are going to resort to some modified form of ‘Russianism’ and attempt to solve these problems by government” (Congressional Record, 1935). In response to such hyperbolic appeals, Chairman Doughton expressed his belief that the act did not undermine private and individual work ethics. According to Doughton, these would be preserved by contributory financing, as “The worker’s right to benefits is conditioned upon his previous employment, social insurance will do nothing to break down the sacred American tradition of self-reliance and initiative” (Congressional Record, 1935). Ultimately, the legislation was opposed by only 37 congressional members.

The Social Security Act

In brief, the main provisions of the bill called for an unemployment compensation program, a compulsory old-age insurance program, and a federal-state matching fund program for assistance to the indigent aged. Both unemployment compensation and old-age assistance were highly decentralized, with the former relying on a federal tax offset designed to encourage states to establish and regulate their own unemployment compensation programs and the latter being financed jointly by general federal revenues set to match the funds each state contributed to their own individually administered program.

According to Edwin Witte’s memoirs, these programs received relatively little congressional attention due to the legislators’ overarching interest in old-age pensions (Witte, 1963). Yet, two substantive changes were made that applied to both provisions. The first was the decision of the Ways and Means Committee to exclude certain groups from coverage, most significantly agricultural workers and domestic servants. This was done at the behest of Southern legislators—who held a majority on the committee—and has been interpreted by most historians as being emblematic of the South’s fierce opposition to federal interfer

ence in the region's handling of racial issues.

The second was the elimination of a stipulation in both provisions that state programs for old-age assistance and unemployment provide benefit levels high enough to ensure “a reasonable subsistence compatible with decency and health.” This requirement was vigorously attacked by Congressman Harry Byrd, Sr. (D-WVA), who argued that it would provide the federal government with extraordinary powers to arbitrarily influence local wages and living standards. In the case of old-age assistance, the removal of this provision prevented the federal government from establishing minimum benefit levels, and resulted in Old-Age Assistance (OAA) programs that varied widely from state to state in terms of benefit levels. For instance in Mississippi, OAA paid only \$3.92 per month in 1938, while in California it paid \$31.36.²

The major part of the congressional and public debate surrounding the Social Security Act involved provisions most germane to the act's old-age insurance component. Considering the magnitude of the legislation, deliberations regarding old-age pensions were surprisingly demur. Yet several key issues were raised, some of which continue to appear in contemporary debates on Social Security. Perhaps one of the most significant concerned an amendment offered by Sen. Bennet Champ Clark (D-MO). Clark proposed to exempt employers operating private pension programs from the old age insurance program. The administration was opposed to such an exemption, fearing that it would result in the public sector being saddled with the responsibility of providing for an undue proportion of “high risks.” In this view, allowing employers who offered a private plan to “opt out” would compromise the program's ability to spread costs, thus jeopardizing its financial stability. Yet despite this opposition, Clark's amendment passed the Senate by a vote 51–35 and was not dropped in conference until Roosevelt made it clear that he would not sign the bill if it contained the exemption clause.

In addition to the Clark Amendment, debates surfaced regarding the use of contributory taxes,

the rate at which such taxation should occur, the significance of an old-age insurance trust fund and the age at which benefits should be received, and whether or not retirement should be a condition of benefit eligibility. These topics are the focus of the next section.

■ The Debates Over Contributory Taxes

President Roosevelt was a strong supporter of contributory taxes. Because this method of financing tied benefits to work history, he believed it was compatible with America's political and economic traditions. Several years after the Social Security Act had been passed, Roosevelt was asked by a reporter to summarize his reasons for insisting that America's public benefits system be funded by contributory taxes. He replied, “We put those payroll contributions there so as to give contributors a legal, moral, and political right to collect their pensions and unemployment benefits. With those taxes in there, no damn politician can ever scrap my social security program” (Achenbaum, 1987). This statement points to one element of payroll taxes that attracted Roosevelt—instituting a system that linked contribution and return would convince the public that they had a vested interest in the program.

However, during the formation of, and debate over, the Social Security Act, reliance on contributory financing was not a given. In fact, there was significant opposition to full-scale contributory financing, and the initial CES report itself called for government contributions to the old-age insurance program.

Contributory Taxes, the Initial CES Report, and Tax Rate Adjustments

Just prior to the CES's formation, Roosevelt stated that the funds for public benefit programs “should be raised by contribution rather than an increase in general taxation.” In meetings with CES staff, the president frequently reiterated his conviction that full reliance on contributory financing was necessary to prevent the emergence of a public “dole.” Considering Roosevelt's popularity and political stature, his opinions weighed heavily on the CES staff. Thus it is somewhat surprising that the

² In 1972, the Old Age Assistance program was replaced by Supplementary Security Income (SSI), a program that is entirely financed and administered by the federal government.

initial committee report recommended using funds from general government revenues in 1965, the year they predicted payroll taxes would no longer cover old-age insurance program costs.

The CES called for general revenues in 1965 primarily because it estimated that progressively less favorable worker-to-beneficiary ratios would eventually require either a reduction in benefits, an unscheduled increase in the payroll tax rate, or a contribution from general revenues. In the original CES plan, benefits were to be paid at a rate set to match 5 percent contributions on payroll—2.5 percent each from employee and employers. However, the tax rate was not scheduled to increase to a joint rate of 5 percent until 1957. The initial tax in 1937 was to be 0.5 percent on both employee and employer, increasing by 0.5 percent every five years until it reaching the maximum rate of 2.5 percent in 1957. Thus any beneficiary who had begun paying payroll taxes prior to 1957 would receive more than he or she had contributed.

This discrepancy would be minimized by a high ratio of contributors to eligible retirees during the program's early years, but as this ratio evened out, a financial imbalance would eventually emerge. In the estimation of the CES, this deficit would begin in 1965, increasing to \$1.4 billion in 1980. The CES proposed that this deficit be met by general revenues but acknowledged that there was no way to ensure that it would not be accounted for by reducing benefits or increasing taxes.

On January 16, 1935, one day before he was committed to sending the CES report to Congress, Roosevelt became aware of the general revenue provision. Calling Secretary Perkins to his office, Roosevelt ordered the financing provisions to be redrafted so that old-age insurance would be entirely financed by payroll taxes. To do this in one day, tables in the report showing future government contributions were omitted and the relevant prose hastily altered. The report did concede that the plan's financing would require revision in the future and a statement was added indicating that "there may be a valid objection to this plan in that it involves too great a cost upon future generations" (Leff, 1983).

To rectify this situation, Roosevelt charged the CES and the U.S. Treasury Department with the task of developing a fully self-financed old-age insurance program. The solution they devised

would be presented to the House Ways and Means Committee by Treasury Secretary Henry Morgenthau and hence become known as the "Morgenthau Amendment." The revisions Morgenthau proposed—and which were adopted—ensured that the old-age insurance program would be sufficiently financed until at least 1980. This was accomplished by raising tax rates, speeding up the intervals at which these rates increased, and reducing pensions for early beneficiaries.

Under the new plan, the initial tax on both employers and employees was set at 1 percent, increasing by 0.5 percent every three years until a maximum of 3 percent was reached in 1949. However, these revisions not only ensured the program until 1980, they also generated a reserve fund of \$50 billion. The existence of this fund would become the source of considerable debate.

Opposition to Contributory Financing and the Trust Fund

In Roosevelt's view, the problems that could be linked to a sizable old-age reserve fund were insignificant when contrasted with the drawbacks of using general revenues to finance public benefit programs. In fact, some historians have suggested that Roosevelt was sympathetic to a large reserve fund because of advantages he believed it would yield. Namely, they point to Roosevelt's rarely appreciated fiscal conservatism, noting that he supported a balanced budget and only sacrificed this principle in the face of the terrible economic conditions that immediately confronted his administration.

Yet even in light of these circumstances, Roosevelt remained concerned about the debt being incurred by his recovery programs. Building on this, historians who claim that Roosevelt supported the reserve fund argue that he did so out of recognition that payroll tax surpluses could be invested in the public debt, thereby reducing net demands on the Treasury. That Roosevelt was aware this could be done is clear—Morgenthau gave testimony to this effect before the Ways and Means Committee—although it remains uncertain that this awareness contributed to his insistence on raising the tax rates proposed in the initial CES report.

Thus various explanations have been advanced to explain Roosevelt's allegiance to a fully

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self-financed old-age insurance program. As discussed earlier, one of these was his belief that contributory financing would politically secure the viability of old-age insurance by convincing individuals that they had an “earned right” to benefits and thus drawing their allegiance to the program by providing them with a sense of participation. Related to this, it is well known that Roosevelt had a canny sense of the cyclical nature of politics. He was aware that, although circumstances provided a propitious political climate for innovative liberal policy in the 1930s, these circumstances would eventually change, and with them, so would political proclivities. When this occurred, Roosevelt wanted to ensure that the old-age insurance program would not be identified as “emergency legislation” and consequently deemed no longer necessary. Avoiding this, Roosevelt was convinced, required the establishment of a program that was both self-supporting and strongly backed by the voting public. In his view, contributory financing could accomplish both these goals.

However, opposition to full contributory financing came from two camps. One argued that payroll taxes were overly regressive and the other that economic growth would be impeded by the large reserve fund such a system would create. Those concerned with the regressivity of contributory financing claimed that employers could pass the full burden of payroll taxes along to workers, either in the form of higher prices or lower wages. Referencing this position, several key political and social figures called for a system that would pay greater heed to tax equity. Notable among these were cabinet official Harry Hopkins, Senator and future Supreme Court Justice; social insurance theorists Isaac Rubinow and Abraham Epstein; and two highly respected Congressmen, Henry Ellenbogen (D-PA) and Rexford G. Tugwell (D-NY). According to Epstein, in testimony to the House Ways and Means Committee, full contributory financing would yield, “a system of compulsory payments by the poor to the impoverished that relieves the well-to-do from their share of the social burden” (Lubove, 1968).

To remedy this, those alarmed by the perceived regressiveness of the program advocated one of two solutions. The first called for exempting persons in low-income groups from the payroll tax. The advantages of this were summarized by E. J.

McCormack, who served as a special assistant to the Social Security Administration’s predecessor, the Social Security Board, in 1936. According to McCormack, “Fifty cents a month (the average amount low-income workers would save if exempted) is equivalent to four plus quarts of milk, and that much milk during the month to an infant might prove a better investment in human values than the same amount put away over a period of years to provide for the old-age of that infant’s father” (Cates, 1983).

The second solution proposed by opponents of contributory financing called for a tax increase on business and the wealthy in order to fund old-age insurance with general revenues. According to Ellenbogen:

There is one defect in this old-age insurance system as set up in the act of Congress, a vital, a fundamental defect. The Federal Government does not contribute to it. The Federal government, as in many European countries, should contribute one-third of the total fund. Where will it get the money? I do not want to use this speech as a springboard for a dissertation on the maldistribution of wealth and income in this country, but I will venture to state that in a country where 87 percent of the wealth is owned by 4 percent of its population, inheritance and income taxes could well be increased for this purpose³ (Congressional Record, 1935).

Ultimately, however, although this opposition created a sense of urgency that expedited action on the CES proposal, it failed to effect the structure and provisions of the Social Security Act. In addition to Roosevelt’s concerns about the long-term political viability of the program, scholars offer a broader explanation for this failure. At the time, federal taxing powers were extremely limited. Most

³ *Proposals that reflected the Ellenbogen’s sentiment included the Lundeen Bill and Sen. Huey Long’s Share-Our-Wealth campaign. Both plans called imposing considerable taxes on wealth and businesses, and redistributing this money to the aged and unemployed. In March 1935, the Lundeen Bill passed through the House Labor Committee, and Sen. Long had gained enough support nationally to concern the White House that his entrance into the 1936 presidential election as a third party candidate could jeopardize Roosevelt’s chances for reelection.*

federal revenue came from tariffs or sales tax on non essential items such as furs and cigarettes. Although an income tax had been instituted earlier in the century, by the time of the Depression, it remained highly underdeveloped. In fact, in the early 1930s, over 95 percent of the U.S. population was exempt from all taxes. Thus to subsidize a program as massive as old-age insurance with general revenues would have required a complete overhaul of the tax system and, notably, an increase in direct taxation.

According to some scholars, the logistics of accomplishing this, coupled with the fact that raising direct taxes in the midst of a depression would be unpopular at best, precluded significant reliance on general revenues. Full contributory financing was also opposed by those who feared that the system's large reserve fund dangerously privileged savings over consumption. From their perspective, excessive savings were already placing a massive drag on the American economy, and the key to ending the Depression was growth spurred by consumption.

Expert testimony critical of the reserve was given before the House Ways and Means Committee and in the Senate, but no proposal for reducing the reserve was offered. It was not until two years after the act was passed that the issue of the old-age insurance reserve gained prominence, ultimately leading to major revisions of the Social Security system passed in 1939.

■ The Reserve Fund and the 1939 Amendments

Following the Social Security Act's passage in 1935, it continued to face considerable challenges. The logistics of starting up the new system were immense; many businesses resisted compliance; the constitutionality of the act was unresolved; and many groups, most notably the Townsend Movement, continued to push for more generous benefits. Compounding these problems, a severe recession hit the country in 1937, and observers seeking to explain this downturn quickly pinpointed the reserve fund, which had already withdrawn approximately \$2 billion in payroll taxes from the economy. Calls mounted to address this accumulation of reserves, and Sen. Arthur Vandenburg (R-MI), who said of the reserve fund "it

is scarcely imaginable that rational men should propose such an unmanageable accumulation of funds in one place in a democracy," called for reducing the reserve by liberalizing benefits and instituting a payroll tax freeze (Tynes, 1996). It was hoped that this increase in benefit payments and decrease in taxes would stimulate the economy through encouraging consumption. Responding to Vandenburg's proposal and accompanying pressures, Roosevelt formed the first ever Advisory Council on Social Security, charging them with the task of suggesting reforms that would defuse attacks on the program.

Ironically, the council's final report, issued on December 10, 1938, called for changes that practically eliminated the effects of the Morgenthau Amendment. The report called for accelerating the initial benefit payment schedule, increasing benefit amounts as well as the covered population, and freezing tax rate increases. In the amendments of 1939, passed with only 10 dissenting votes, each of these recommendations was enacted: the date of beginning payments was moved up to 1940; retirement payments in the first years of the program were increased; coverage was extended to the survivors of both active and retired employees who had died and to the dependents of retired workers; and the tax rate was frozen at 1 percent for a period of 11 years.

These changes pleased a wide spectrum of the population, appealing to business through the tax freeze and workers through benefit increases and expansions, but they also seriously altered two of the program's original tenets. First, the contractual insurance principle—i.e., the close linking of benefits and contributions—was dramatically weakened. With benefit rates for early recipients now raised above 5 percent and taxes frozen at 1 percent until 1949, the program became less actuarially sound than it had been in the original CES plan rejected by Roosevelt. Second, shifting from a reserve funded system to a pay-as-you-go system opened up the possibility that future generations would be forced to meet benefit claims either by raising taxes or dipping into general revenues. This prospect, particularly in light of the willingness of Congress in 1939 to raise benefits but not taxes, alarmed many Social Security supporters. In his diary, Morgenthau feared that

the revisions “may be a device that will eventually kill Social Security,” and Witte found himself with “a sinking feeling about the future of old-age insurance” (Leff, 1983).

■ Retirement Age and Related Issues

Although the topic did not receive significant attention during the formation of Social Security, alternatives to the benefit eligibility age of 65 were suggested. There was considerable support, especially from labor leaders, for setting the age at 60. They argued that the nature of industrialization had accelerated the rate at which a human became incapable of productive work. Consequently, they suggested that the act disregard the precedent of age 65 established in Europe and provide full benefits at age 60. Reinforcing their arguments, proponents of age 60 noted that life expectancy at birth in 1929 was only 57.7 years for males. According to Ellenbogen, “The 65 year limit...must go. It is entirely too high. After all, this is supposed to be a pension for old-age, not a graveyard pension” (Congressional Record, 1935).

Several officials from the CES and the Treasury Department, concerned with long-range financing, advocated age 70. They were strongly opposed to making benefits available at age 60, arguing that this would greatly imperil the system’s capacity to be self-supporting. It is generally agreed that the selection of age 65 was a compromise between those advocating age 60 and those advocating age 70. Of greater interest was the question of whether or not completely leaving the labor force should be a condition of receiving benefits.

Two historical interpretations have emerged concerning the retirement provisions. The first suggests that moving older workers out of the labor force in order to make room for younger ones was only a minor motivation of the act. Supporters of this position note that the original act contained no provision mandating retirement at age 65. In fact, in the version of the bill that passed through the House, individuals became eligible for full benefits at age 65 *regardless* of whether or not they continued to work. Eventually, through an amendment added in the Senate and approved in conference, this was altered so that individuals who continued

working at age 65 would not become eligible for benefits, although they could defer benefits and continue working.

The historical record pertaining to this revision tends to indicate that the basis of the Senate amendment was actuarial and not due to a desire to improve employment conditions. In the 1939 amendments to the act, the “retirement test” was modified to allow persons to continue working and receiving old-age insurance benefits as long as their earnings from “covered” employment did not exceed \$15 per month.

Conversely, some historians suggest that providing encouragement for elderly workers to exit the labor force was a significant motivation for the Social Security Act. According to these scholars, the prime component of this motivation was a desire to undercut radicalism by providing the unemployed and disenfranchised with gainful employment.

It is clear that one of the goals of social insurance is the reduction of social turmoil. In the opinion of Wilbur Cohen, this was the founding basis of social insurance, whose “roots came out of the work and consideration of the people in the field of labor legislation. Social insurance to them was a form of remedial legislation to deal with the problems of labor unrest in an industrial society” (Domhoff, 1990). Old-age insurance would address “labor unrest” by retiring older workers and converting them into consumers through the provision of a pension. In turn, jobs would immediately be created as spending spurred economic growth. Illustrating this principle, Rep. Reuben Wood (D-MO), drawing an analogy to pending legislation to begin a federal pension program for railroad workers, stated, “If it should go into effect, it is estimated that in the first year it will take out of service approximately 250,000 railroad men, placing them on a pension or annuity. That would naturally make openings for 250,000 younger men” (Tynes, 1996).

Roosevelt himself seemed sympathetic to this rationale, emphasizing that the key to recovery was employment and work, not relief. It was his hope that the assistance-based provisions of the bill would eventually recede in importance, and he believed that reducing unemployment was essential for this to occur. Thus, in consultation with the CES, he considered including a mandatory retirement provision in the original bill. However this

was never done, and a serious attempt to do so would not again surface during the act's inception.

■ The Maturing of Social Security

Social Security is one of our nation's most important social programs. However, the growth of the program, and perhaps even its existence, remained uncertain until 1950. Throughout the 1940s, old-age insurance was outpaced by public welfare provisions, both in terms of beneficiaries and benefit levels. In this climate, interest in the program waned, and its very necessity was questioned by many. On several occasions, Congress canceled scheduled increases in tax rates, reasoning that there was little demonstrated need for program expansion. OAI was further hampered with the outbreak of World War II, which pushed domestic issues into the political background. After the war, when a depression did not materialize as many feared, suggestions began to mount that means-tested programs could sufficiently address the issue of old-age security.

Despite these unfavorable circumstances, Social Security was expanded in 1950. Benefits increased by 77 percent. The tax level was raised to 3 percent, with both employer and employee contributing 1.5 percent, and the taxable wage base was raised from \$3,000 to \$3,600. In addition, the payroll tax was extended to include self-employed workers, who were taxed at a rate of 2.25 percent of taxable payroll. Several factors contributed to this expansion, with two being particularly significant. First, the actions of an Advisory Council convened in 1948 persuaded legislators that elderly dependence on the dreaded public "dole" could only be lessened through the expansion of OAI. Here, the same arguments used to ensure the act's original passage—developing a system that linked benefits and contributions—were again invoked. Second, beginning in the late 1940s, several labor unions pressured for and received private pension plans. Benefit levels in these employer-sponsored plans were set at a specific level and tied to Social Security. For instance, the Big Three offered a monthly retirement pension of \$100, with the company providing the difference between this amount and the OAI benefit level. As a result of this link, employers could decrease their contributions in proportion to OAI benefit increases.

Consequently, many became interested in expanding Social Security, and several historians suggest that this interest was crucial to the passage of the 1950 amendments.

It is generally agreed that the 1950 amendments "saved" Social Security, placing it on a path of steady incremental expansion. Shortly after the amendments were passed, the number of persons receiving OAI surpassed the number of old-age assistance beneficiaries, and in August 1951, OAI paid out more in benefits than old-age assistance for the first time in U.S. history. OAI continued to expand throughout the 1950s, benefiting from steadily rising wages and favorable worker-to-beneficiary ratios. Combined, these factors allowed legislators to raise benefits *without* raising payroll taxes. Coverage too was expanded, with agricultural workers incorporated into the system in 1953.

That much of the program's growth occurred with the blessing of a Republican President (Eisenhower) reflected the bipartisan support for OAI that had emerged by the mid-1950s. The parties were clearly not in complete unison—as indicated by the experience of Disability Insurance (DI), narrowly enacted in 1956 after contentious debate and staunch Republican opposition—but both were committed to the general principles and existence of OAI, something that had not been the case less than 10 years earlier. Additionally, public opinion polls recorded that OAI was one of the most popular government programs. Thus both in terms of political and public support, Roosevelt's desire for a politically "untouchable" old-age insurance program was reaching fruition.

Social Security continued its growth in the 1960s, with OASDI benefit levels being increased in both 1968 and 1969. In 1965, the Social Security Act was expanded to include health insurance for OASDI beneficiaries. Known as Medicare, this amendment was the product of extensive compromises between advocates and opponents of comprehensive national health insurance, and it built carefully on traditions well established by the Old Age Survivors Insurance program. For instance, eligibility for Medicare was contingent upon eligibility for OASDI; both programs were predominantly financed via payroll taxes; and both programs were portrayed as "earned" rights, attained through contributions made during one's

working years.

Beginning in the 1970s, policy and rhetoric concerning Social Security shifted away from gradual expansion and toward preservation and sustainability. This shift was, and is, a product of changing demographic and economic circumstances. In a pay-as-you-go retirement program, the ability to raise benefits more rapidly than payroll taxes is contingent upon two factors: favorable worker-to-beneficiary ratios and steadily rising wages. Throughout the 1950s and 1960s, both of these conditions existed. However, in the early 1970s, this began to change. Economics struck first, as productivity declined, driving prices upward and wages downward. This had dual negative effects on Social Security because benefit increases had been indexed to the rate of inflation in 1972. As a result, rising prices automatically resulted in rising benefits. However, wages were not keeping pace. As a result, OASDI was saddled with increased liabilities (higher benefit payments) and decreased revenue opportunities (a decreased tax base).

By the early 1980s, this bifurcation between wage increases and benefit increases was growing rapidly, with many suggesting that the trend was unsustainable. For instance, benefits automatically increased by 14.3 percent in 1980, but wages rose only 9 percent. Alarmed by these conditions President Reagan charged a bipartisan commission with the task of resolving the crisis. This ultimately led to several revisions in the Social Security program, including the taxation of some benefits, the inclusion of new federal employees in the OASDI system, a six-month delay in automatic cost-of-living adjustments, and small payroll tax increases. Additionally, the normal retirement age was raised, with an increase to age 67 beginning in 2003.

These revisions largely addressed the financing dilemmas confronting OASI in the early 1980s. In 1983, the OASI Trust Fund balance stood at \$19.7 billion. Today it is over \$440 billion. Yet, although the program's short term finances are ensured, pending demographic changes threaten its long-range solvency. Additionally, unfavorable demographics are undermining current and projected rates of return. As the number of beneficiaries grows more rapidly than that of covered

workers, the OASI tax base declines and its obligations increase. For instance, in 1960, a single retiree could expect to receive benefits between seven and nine times higher than his or her total payroll contributions. By 1980, this favorable rate of return had declined to two to three times the rate of contribution, and projections suggest that workers retiring in 2025 will receive benefit payments equal to only 75 percent to 90 percent of their total lifetime contributions. Currently, there are 3.2 workers per beneficiary. In 2025, it is projected that there will be 1.9 workers per beneficiary.

Traditionally, Social Security finances are viewed by analysts over a 75-year period.⁴ Due to unfavorable demographic trends and continued rates of slow productivity, OASDI is underfunded over such a period by 2.17 percent of covered payroll. Combined with trends that clearly indicate diminishing rates of return for OASDI participants, this level of underfunding has prompted many to suggest that Social Security is in need of fundamental reform. Two suggestions that would significantly alter the program have emerged—privatization and “affluence” testing.

The passage of Social Security meant that, for the first time, the federal government was in the business of organizing social insurance. Prior to this, individual effort and family support were the sole guarantors of financial security in old age. However, in shaping the Social Security Act, policymakers paid careful attention to the ethos of individual effort—i.e., they tied effort to reward by relying on contributory financing. In this sense the philosophical underpinnings of Social Security contain a healthy respect for private initiative and individual effort. But the rate of return to people with careers marked by higher wages is compromised in favor of supporting those with lower lifetime earnings. These low rates of return, in conjunction with unfunded liabilities in the future, bring us right back to the struggle to define the role of social insurance in our market-based economy.

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⁴ *Seventy-five was selected because it approximates one lifetime.*

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3

EBRI Social Security Reform Analysis Project Progress Report: Phases 1 and 2

by Martin R. Holmer

■ Preface

This report was produced as part of the Employee Benefit Research Institute (EBRI) Social Security reform project. (A previous version of this report was presented at the EBRI Policy Forum on “Assessing Social Security Reform Alternatives” in December 1996.) While the model development effort was not complete, it had progressed far enough to provide some unique insights into the nature of the Social Security problem and the benefits, cost, and risks of alternative approaches to solving the problem. Subsequent work under the EBRI Social Security reform project will produce a more complete narrative of the results outlined here.

■ Understanding via Quantitative Analysis

This section describes the role of quantitative analysis in understanding the nature of the Social Security problem and in assessing the benefits, costs, and risks of alternative proposals for reforming current Social Security policy.

First, a short account of the recent broadening of the reform debate shows why a new kind of policy simulation model is needed to conduct a fair and complete analysis of the structural reforms that have been proposed in the past few years. Models that were adequate for analyzing the nonstructural reforms that dominated the earlier debate are not designed to address many of the key issues raised by the new structural reform proposals.

Second, a short description of the EBRI-SSASIM2 stochastic policy simulation model is provided. This model is being developed to enable a fair and complete comparison of the benefits, costs, and risks of a wide range of Social Security reform proposals.

■ Rationale for a New Kind of Model

A major premise of the EBRI Social Security reform project is that better understanding of the problems current-law Social Security policy faces requires quantitative analysis that estimates all the benefits, costs, and risks of the program. Likewise, quantitative analysis of all benefits, costs, and risks is required for a fair and complete comparison of the broad range of reform proposals that are being offered as solutions to these problems.

The emphasis on quantitative analysis is rooted in the belief that any careful assessment of a proposed change requires estimates of the effects of that change. Because the effects of changes in Social Security policy will take many decades to become apparent, computer simulation is the only viable method of estimating the effects of change. Stochastic simulation is the appropriate analysis method because the effects of a policy change often depend on the size and composition of the population and on the state of the economy, neither of which is known with certainty in the future. Use of Monte Carlo simulation methods permits quantitative estimates of how the effects of policy reform will vary depending on the state of the economy and the size and composition of the population.

The scope of current reform proposals is much broader than in the past. For example, some reform proposals call for equity investment of the trust funds, while others call for the creation of self-managed personal retirement accounts. The range of analysis issues raised by such major structural reforms is much broader than those raised by the nonstructural reforms that have been analyzed over the past several decades.

This broadening of the scope of analysis has created demand for new kinds of quantitative analysis tools. Policy simulation modeling has a

Assessing Social Security Reform Alternatives

long tradition in the Social Security policy analysis community, but the kinds of models currently in use are designed to analyze the nonstructural reforms that have dominated debate in the past. These older models are not well suited to analyze many of the new issues raised by the structural reform proposals.

Many of the shortcomings of current models stem from the fact that they are not designed to analyze defined contribution-style personal accounts or risky investments. But having quantitative estimates of both average results and the variability of those results is essential to any evaluation of a policy's benefits, costs, and risks.

In addition, current models fail to provide an adequate method of characterizing the economic feedback effects of Social Security policy. Reform proposals that call for major changes in retirement ages and/or introduction of personal retirement accounts are likely to affect aggregate work effort and national saving in ways that alter the pattern of economic growth, which in turn can affect program tax revenues and benefit costs.

Considering this broadening in the scope of Social Security policy debate, it is clear that there is a need for a new kind of policy simulation model that can provide quantitative estimates for the full range of benefit, cost, and risk issues that are now being addressed in discussions of alternative policy reform proposals. Current modeling technology, which is adequate to support yesterday's policy discussion, needs to progress to support today's discussion, which focuses on the effects of major, structural reforms in Social Security policy.

EBRI-SSASIM2 Model Overview

The model is a dynamic and stochastic policy simulation of the current Social Security system, reforms in that defined benefit system, and proposals for introducing defined contribution features into the system. The model extends in numerous ways the capabilities of the original SSASIM model, which was developed for the Social Security Administration's Advisory Council. The basic capabilities of the original model and the new model's major enhancements are described in turn.

The SSASIM model was originally developed to explore the use of Monte Carlo simulation methods to characterize the demographic and economic uncertainty facing the Social Security

program. Exploration of this stochastic simulation method was a major recommendation of the prior Technical Panel on Assumptions and Methods, as well as the panel appointed by the current Advisory Council. Initial demographic modeling results were reported in the panel's final report. The Advisory Council sponsored additional model development, which added economic, asset return, tax, and simplified benefit modules, to enable the model to analyze the risks as well as the benefits and costs of equity investment options in the trust funds.

After this initial stage of model development, the model's logical structure, including its input assumptions and output results, was similar to that of the Social Security Administration's Actuarial Model. The major differences were that program-related risks were explicitly represented using Monte Carlo methods and that several economic feedback effects were designed into the model. Monte Carlo methods are used to characterize uncertainty about the future course of 13 key demographic and economic input variables used in the Social Security Actuarial Model, as well as uncertainty about future asset returns. Operating in a nonstochastic mode, the model closely replicates each of the three scenarios presented in the Trustees' Report.

The range of reform proposals currently being discussed requires an enhanced model to assess fairly the benefits, costs, and risks of different proposals. The EBRI-SSASIM2 model builds directly on the earlier model and adds major enhancements in a number of important areas:

- Implementation of *structural benefit modules* that enable more detailed analysis of a wide range of benefit reforms in the current defined benefit Social Security structure.
- Implementation of *economic feedback linkages*, including a saving, investment, and productivity growth linkage and an asset-allocation, relative asset returns linkage.
- Development of *cohort lifetime experience analysis capabilities* that produce policy performance indicators (such as money's worth return) from the same model and assumptions that produce aggregate program financial results and use realistic age-earnings' profiles.
- Development of *cohort policy performance indicators* that measure not only the average program experience of a cohort and different

cohort subgroups but also measure the risks that alternative policies impose on different cohort groups.

- Development of *personal retirement account modules* that represent the basic features of a range of current defined contribution reform proposals and characterize the range of account balance, asset-allocation, and annuitization behavior.
- Use of *stochastic asset returns* to model realistically the pattern of accumulation of personal retirement account balances.

■ Examining the Nature of the Problem

This section begins the examination of the future cost of current-law Old-Age and Survivors Insurance (OASI) benefit policy by looking at results from the best-guess, single-scenario projection used in the Trustees' Report. It continues by establishing the demographic roots of current-law benefit policy's long-run actuarial deficit. Next, it examines the uncertainty of future costs, using assumptions about future variability in the demographic and economic environment of the program that are consistent with those assumed in the Trustees'

Report. Then it estimates the cost effects of changing only the rate of mortality decline from the assumption used in the Trustees' Report to an assumption that is closer to that of the Census Bureau. The section concludes with a discussion of the size and timing of the OASI cost problem.

Future Cost of Current-Law Benefit Policy

The cost of OASI benefit policy will rise sharply as baby-boom cohort members begin to retire. The current level of payroll tax rates will not be sufficient to finance these higher costs. See chart 3.1 for details.

The cost problem remains even after most baby-boom cohort members have died in 2070. Chart 3.1 shows the gap between costs and income in 2070.

The long-run average cost rate and long-run average actuarial deficit estimates understate extent of the cost problem because they include current low costs and current program surpluses. Table 3.1 shows difference the between 2070 and long-run average cost rates and deficits.

EBRI-SSASIM2 model, when running in non-stochastic, single-scenario mode with the same intermediate-cost demographic and economic assumptions, produces estimates that are similar to

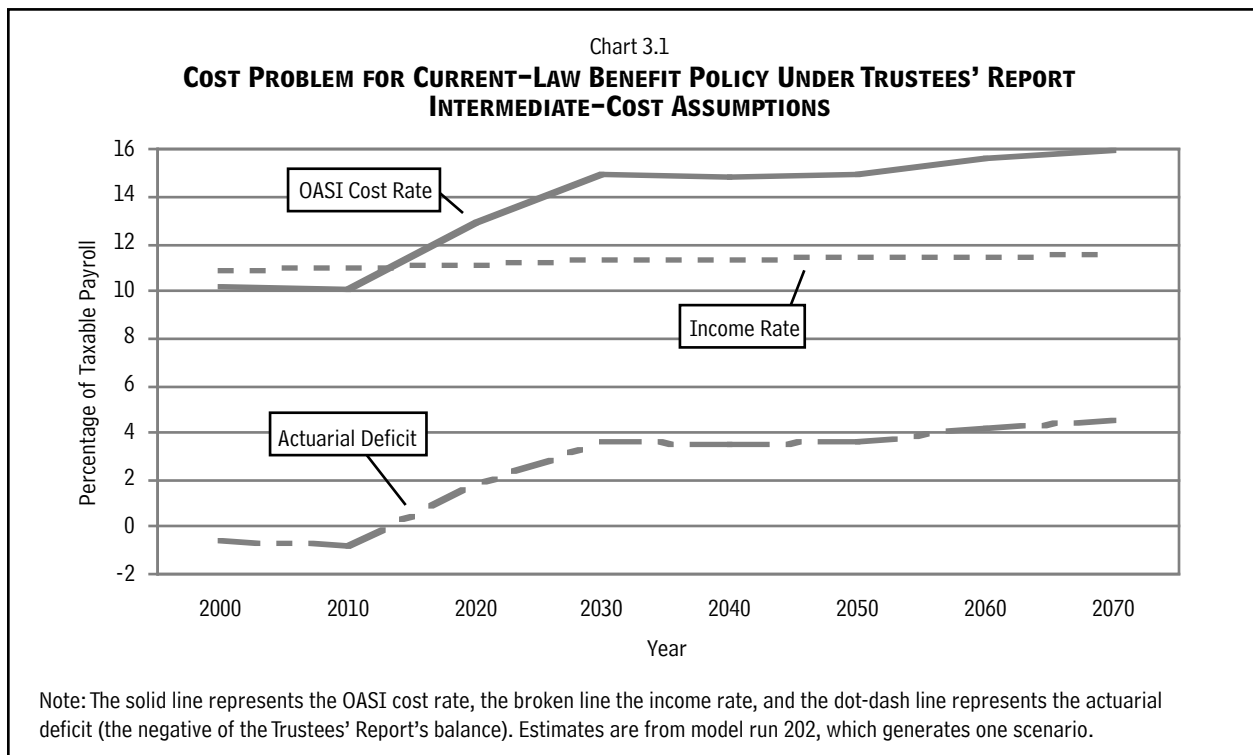


Table 3.1
SUMMARY ESTIMATES OF COST PROBLEM FOR CURRENT-LAW BENEFIT POLICY UNDER TRUSTEES' REPORT INTERMEDIATE-COST ASSUMPTIONS

Source of Estimates	Long-Run Cost Rate	Long-Run Deficit	Cost Rate in 2070	Deficit in 2070
Model Run 202	13.26	1.84	15.91	4.44
1996 Trustees' Report	13.33	1.85	16.39	4.91

Note: The long-run cost rate (deficit) refers to the Trustees' Report's 75-year summarized cost rate (negative actuarial balance). All estimates are expressed in terms of percent of taxable payroll. [96TR, p.108 & p.113]

those in the 1996 Trustees' Report. See table 3.1 for a comparison of these estimates. Not shown is the close agreement between model and Trustees' Report estimates under both the low-cost and high-cost assumptions.

Demographic Roots of the Cost Problem

Life expectancy at birth has risen from less than 64 years in 1940, when Social Security first paid benefits, to over 76 years today. Even though the intermediate-cost assumptions used in the Trustees' Report project a future rate of mortality decline that is substantially below the average rate of the 20th century, life expectancy is estimated to continue to increase, reaching age 81 by 2070

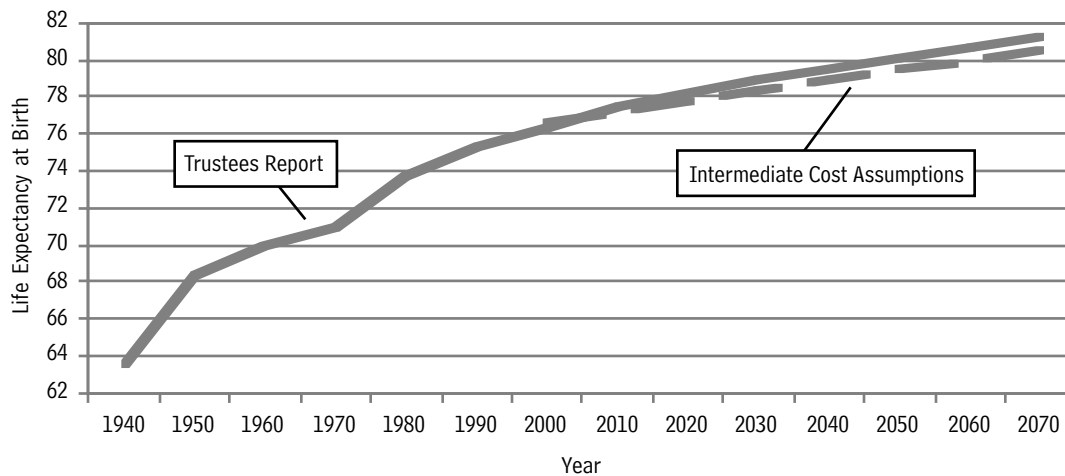
(chart 3.2).

Shorter life expectancy would eliminate the Social Security cost problem as shown in table 3.2. This indicates that the future problem is rooted in the relatively small adjustment in current-law benefit policy (i.e., no change in the early retirement age of 62 and a planned increase in the normal retirement age from 65 to 67) in the face of a substantial increase in life span.

Cost Uncertainty Using Trustees' Views

Future values of demographic and economic variables that influence OASI cost and income cannot be accurately forecast over the next 75 years. The Trustees' Report recognizes this in an

Chart 3.2
HISTORICAL AND PROJECTED LIFE EXPECTANCY AT BIRTH UNDER TRUSTEES' REPORT INTERMEDIATE COST ASSUMPTIONS



Note: The solid line represents historical values before 2000 and Trustees' Report estimates beginning in 2000. The broken line represents estimates using intermediate-cost assumptions from the single-scenario model run 202. In both cases, male and female life expectancy is averaged to obtain a combined life expectancy.

Table 3.2
**SUMMARY ESTIMATES OF COST PROBLEM FOR
 CURRENT-LAW BENEFIT POLICY ASSUMING
 SHORTER LIFE EXPECTANCIES**

Assumed Constant Life Expectancy	Long-Run Deficit	Deficit in 2070
76.28	1.18	2.70
72.60	-0.09	1.14
69.55	-1.12	-0.09

Note: All estimates assume no mortality decline from initial mortality rates that have been increased to simulate earlier historical life expectancies. The cost estimates are from model run 204, which is a nonstochastic, single-scenario run using intermediate-cost assumptions except for mortality. All estimates are expressed in terms of percent of taxable payroll.

ad hoc way by presenting low-cost and high-cost scenarios in addition to the intermediate-cost scenario. Table 3.3 gives estimates on how the size of the cost problem varies across these three scenarios.

Table 3.3 also contains OASI cost estimates produced by the EBRI-SSASIM2 model using the three sets of Trustees' Report assumptions. This comparison indicates that the two models produce similar estimates when using the same assumptions. There is wide agreement that this approach needs to be improved so that the effect of future demographic and economic uncertainty on aggregate program cost and income can be determined.¹

Trustees' Report assumptions are used in EBRI-SSASIM2 model run 205 to specify a stochas-

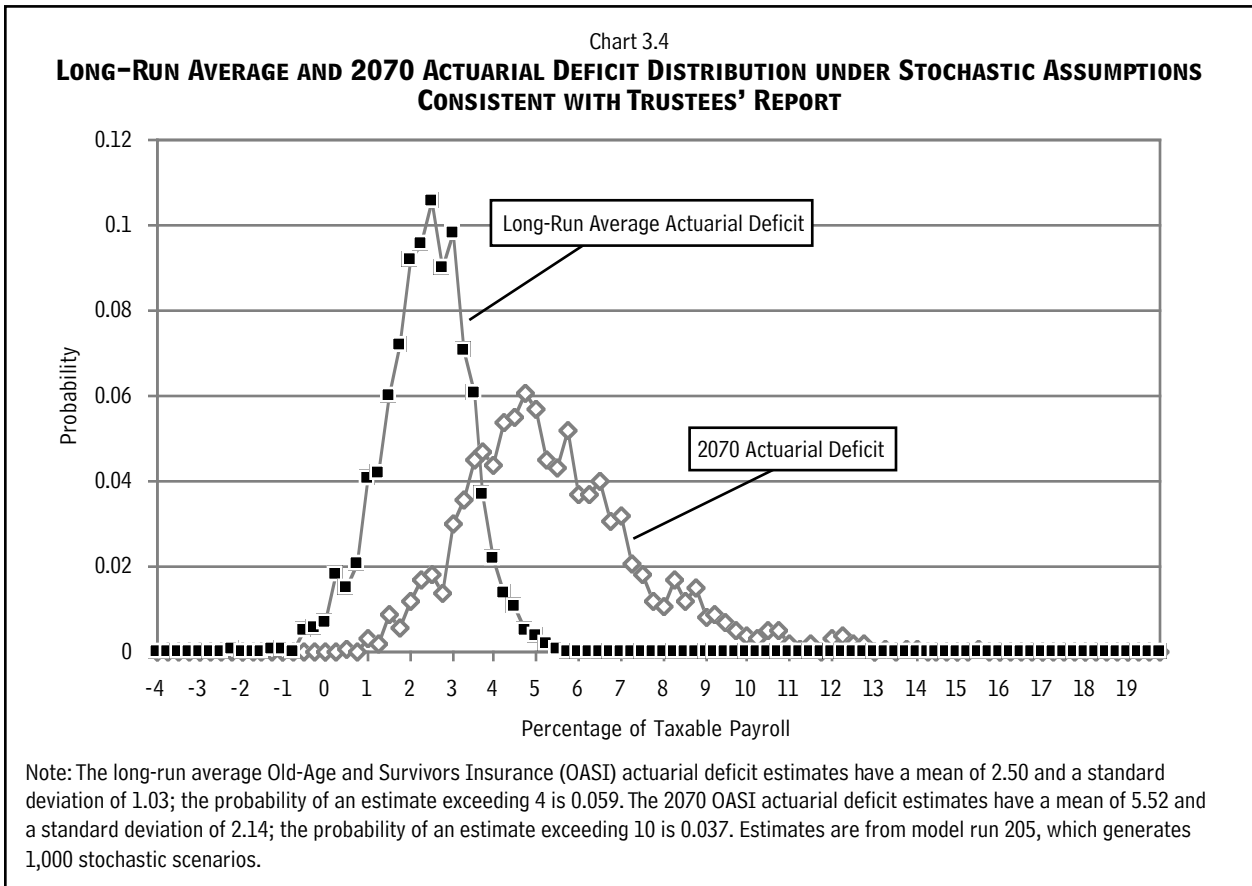
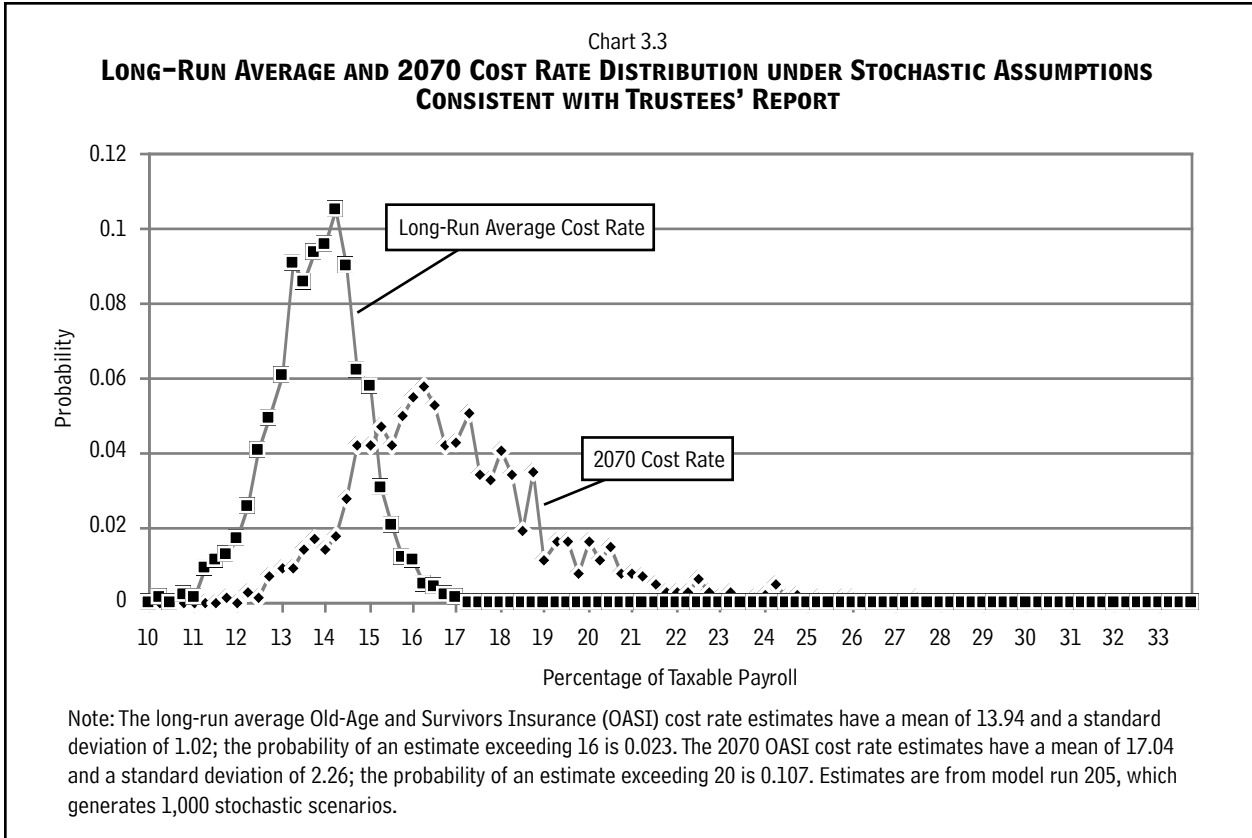
tic simulation that reflects the uncertainty about the future values of demographic and economic variables implicit in the Trustees' Report. Ten of the thirteen major variables that vary across the three Trustees' Report scenarios are assumed to have a constant ultimate value that is drawn from a normal distribution with a mean equal to the Trustees' Report's intermediate-cost assumption and a standard deviation equal to one-fourth of the difference between the high-cost and low-cost assumptions. The long-run, ultimate value distributions of these 10 variables are assumed to be uncorrelated. The three other variables—the unemployment rate, inflation rate, and nominal interest rate—are assumed to fluctuate around means equal to the Trustees' Report's intermediate-cost assumptions, with deviations from the long-run mean being generated by a second-order vector autoregressive process that has been estimated with historical data from the late 1920s through the early 1990s. The errors terms of these three deviation processes were found in the statistical

¹ See, for example, Richard S. Foster, "A Stochastic Evaluation of the Short-Range Economic Assumptions in the 1994 OASDI Trustees Report," Actuarial Study No. 109 (Baltimore, MD: Social Security Administration, Office of the Actuary, 1994); Ronald D. Lee and Shripad Tuljapurkar, "Stochastic Population Forecasts for the United States: Beyond High, Medium, and Low," Journal of the American Statistical Association (December 1994); and the last two reports of the quadrennial Social Security Advisory Council's Technical Panel on Assumptions and Methods.

Table 3.3
**RANGE OF COST ESTIMATES FOR CURRENT-LAW BENEFIT POLICY,
 USING THREE SETS OF TRUSTEES' REPORT ASSUMPTIONS**

Estimate Source	Long-Run Cost Rate	Long-Run Deficit	Cost Rate in 2070	Deficit in 2070
Model Run 201	11.13	-0.19	11.24	0.03
TR Low-Cost	11.09	0.25	11.46	0.25
Model Run 202	13.26	1.84	15.91	4.44
TR Intermediate-Cost	13.33	1.85	16.39	4.91
Model Run 203	16.06	4.52	23.24	11.39
TR High-Cost	16.23	4.61	24.43	12.52

Note: The long-run cost rate (deficit) refers to the Trustees' Report's 75-year summarized cost rate (negative actuarial balance) for OASI. All estimates are expressed in terms of percent of taxable payroll. [96TR. DD.108-109 & D.113]



estimation to be contemporaneously correlated.

Estimates of the degree of cost uncertainty produced by recognizing uncertainty in the future values of these 13 demographic and economic variables are shown in chart 3.3 for the cost rate and in chart 3.4 for the actuarial deficit. The variability in these estimates shows the considerable cost uncertainty facing the OASI program, which is roughly consistent with the assumption that the Trustees' Report's high-cost/low-cost range represents a 95 percent confidence interval for the demographic variables and the economic variables other than the unemployment rate, inflation rate, and nominal interest rate.

Cost Uncertainty Using Census' Mortality View

The Trustees' Report assumes that the future rate of mortality decline will decrease well below the average rate over the 20th century. This is a controversial assumption that has a major effect on estimates of the size of the Social Security cost problem. Some demographers are more comfortable with an assumption that projects past mortality decline rates into the future, and others argue that a shift to healthier life styles will increase the rate of mortality decline. In addition, some believe that future biomedical advances will lead to longer life expectancy.

Census Bureau projections of the rate of mortality decline are considerably higher than the Trustees' Report intermediate-cost assumption. The difference between the Census high-range and low-range assumptions is much larger than the Trustees' Report range. Table 3.4 compares different assumptions about the future rate of mortality decline.

EBRI-SSASIM2 model run 215 is specified to be exactly the same as run 205 (the stochastic run consistent with Trustees' Report assumptions discussed above), except that the mean rate of mortality decline has been increased to be consistent with the Census Bureau's mid-range estimate. This implied 1.0 percent mortality decline rate assumption is the same as the assumption recently recommended by the Advisory Council's Technical Panel. The standard deviation of the rate of mortality decline is twice that assumed in run 205, which produces somewhat less variability than indicated by the Census Bureau's high/low range. It was not possible to reproduce the likelihood of rates of mortality decline near the Census Bureau's high-range estimate because the three Census estimates are asymmetric. This interpretation assumes that the high/low range represents a 95 percent confidence interval.

Census Bureau assumptions imply a life expectancy at birth in 2070 that is on average about three years longer than that implied by the Trustees' Report mortality decline assumptions. The probability of life expectancy at birth in 2070 exceeding age 85 grows from one-half percent under the Trustees' Report assumptions to 37 percent under the Census Bureau assumptions. See chart 3.5 for a comparison of the distribution of life expectancy at birth under the Trustees' Report assumptions and the Census Bureau assumptions.

Census Bureau mortality assumptions imply a worsening of the Social Security cost problem. The mean of the long-run actuarial deficit rises from 2.50 percent of taxable payroll to 3.13 percent, with the probability of it exceeding 4 percent rising from 0.059 to 0.265. The mean of the annual actuarial deficit in 2070 rises from 5.52 percent of taxable payroll to 7.05 percent, with the probability of it exceeding 8 percent rising from 0.121 to 0.331. Details of the cost implications of the Census mortality assumptions are shown in chart 3.6 for the cost rate and in chart 3.7 for the actuarial deficit.

Table 3.4
**ALTERNATIVE ESTIMATES OF POPULATION
AGES 85 AND OLDER IN 2050**
(All estimates are expressed in millions of people)

Estimate Source	Population 85+
Actual 1994	3.3
Census Bureau (low)	9.6
Olshansky*	11.4
Trustees' Report (low)♦	11.8
Trustees' Report (intermediate)	14.6
Trustees' Report (high)♦	17.8
Census Bureau (mid)	18.2
Lee*	21.4
Census Bureau (high)	31.1
Vaupel*	39.0
Manton*	48.7

Note: Census Bureau estimates were published in February 1996. Research by sources marked with an asterisk (*) have been supported by National Institute on Aging. Estimates marked with a diamond (♦) are produced by the EBRI-SSASIM2 model; all others are drawn from a National Institute on Aging chart.

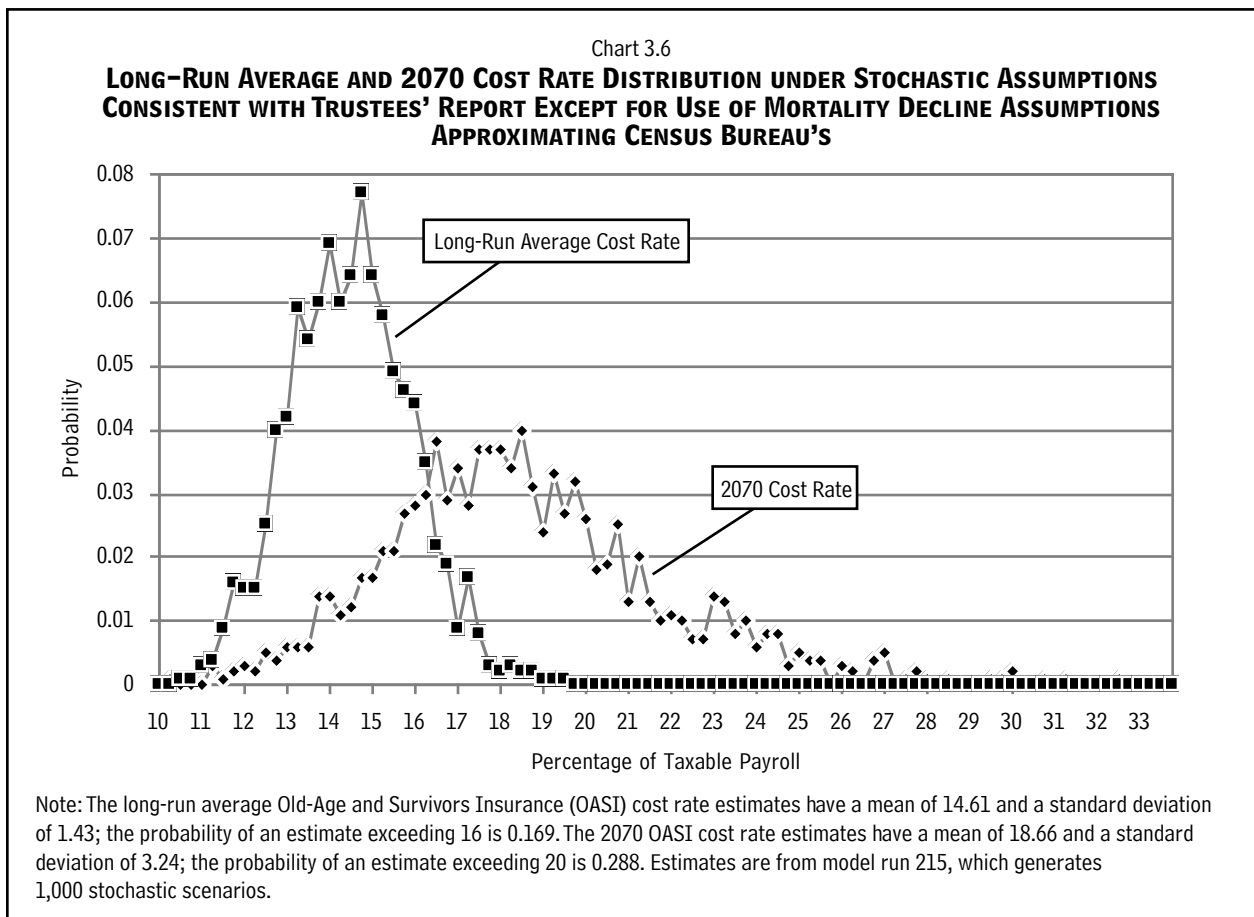
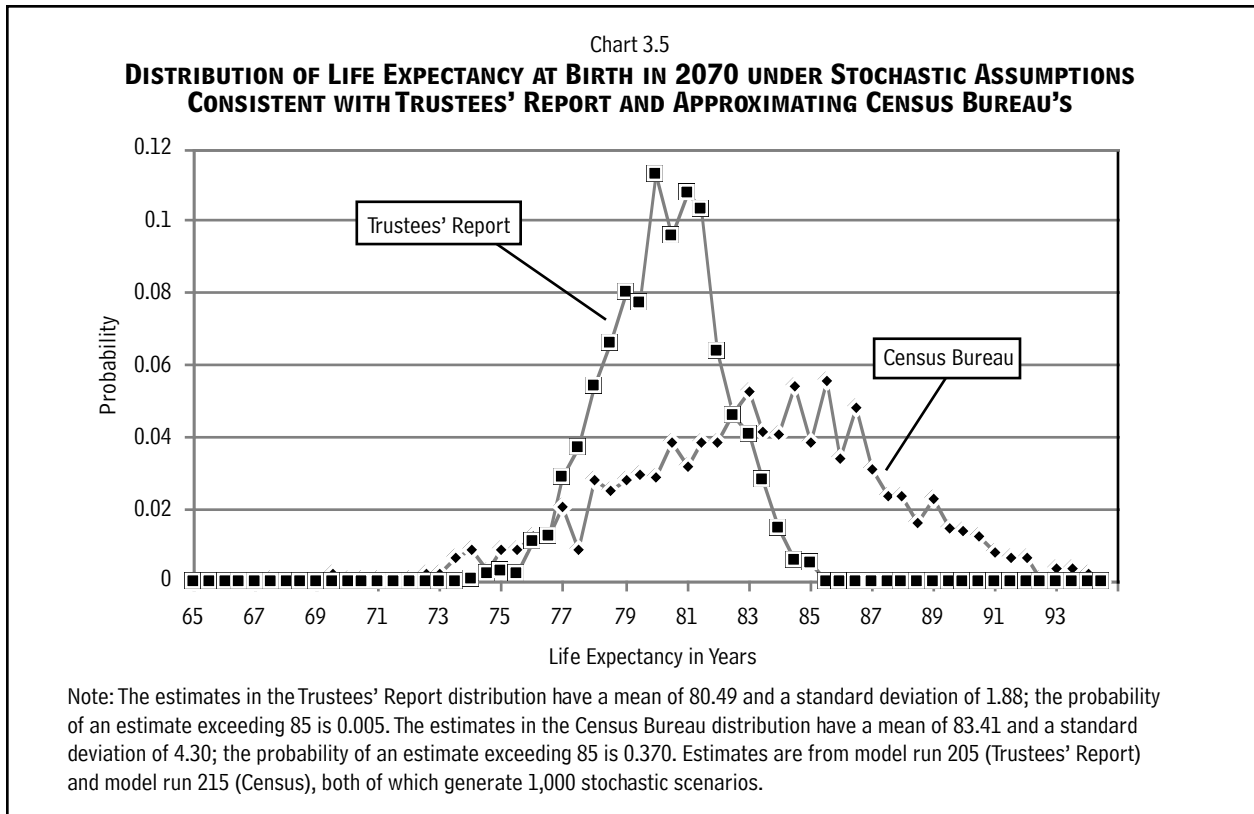
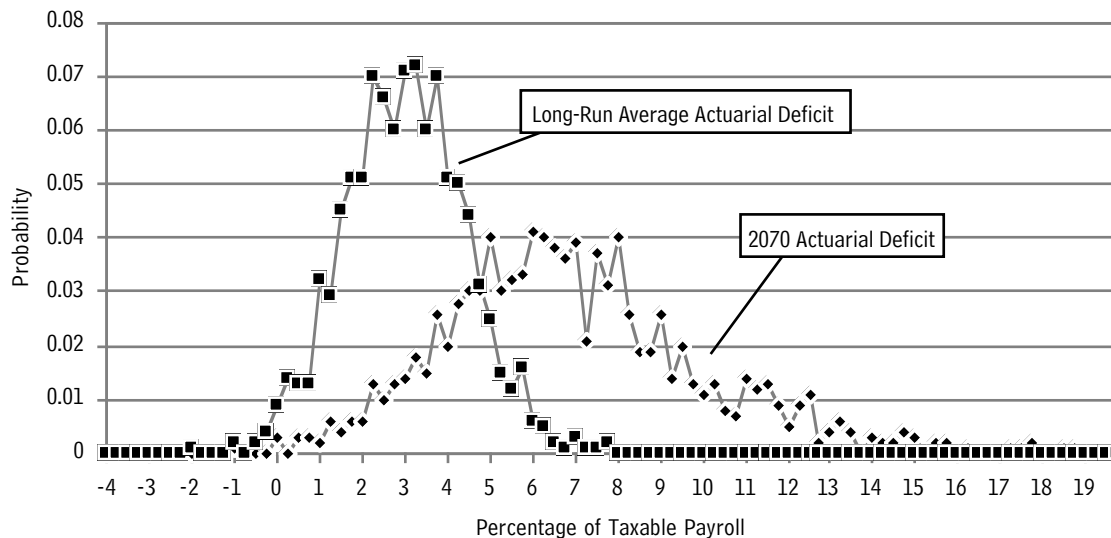


Chart 3.7
LONG-RUN AVERAGE AND 2070 ACTUARIAL DEFICIT DISTRIBUTION UNDER STOCHASTIC ASSUMPTIONS CONSISTENT WITH TRUSTEES' REPORT EXCEPT FOR USE OF MORTALITY DECLINE ASSUMPTIONS APPROXIMATING CENSUS BUREAU'S



Note: The long-run average Old-Age and Survivors Insurance (OASI) actuarial deficit estimates have a mean of 3.13 and a standard deviation of 1.41; the probability of an estimate exceeding 4 is 0.265. The 2070 OASI actuarial deficit estimates have a mean of 7.05 and a standard deviation of 3.06; the probability of an estimate exceeding 10 is 0.154. Estimates are from model run 215, which generates 1,000 stochastic scenarios.

Size and Timing of the Cost Problem

Cost and deficit estimates expressed as a percent of taxable payroll may seem small until they are converted to dollar amounts, which is the standard way of expressing most government program costs and the federal government's overall deficit.

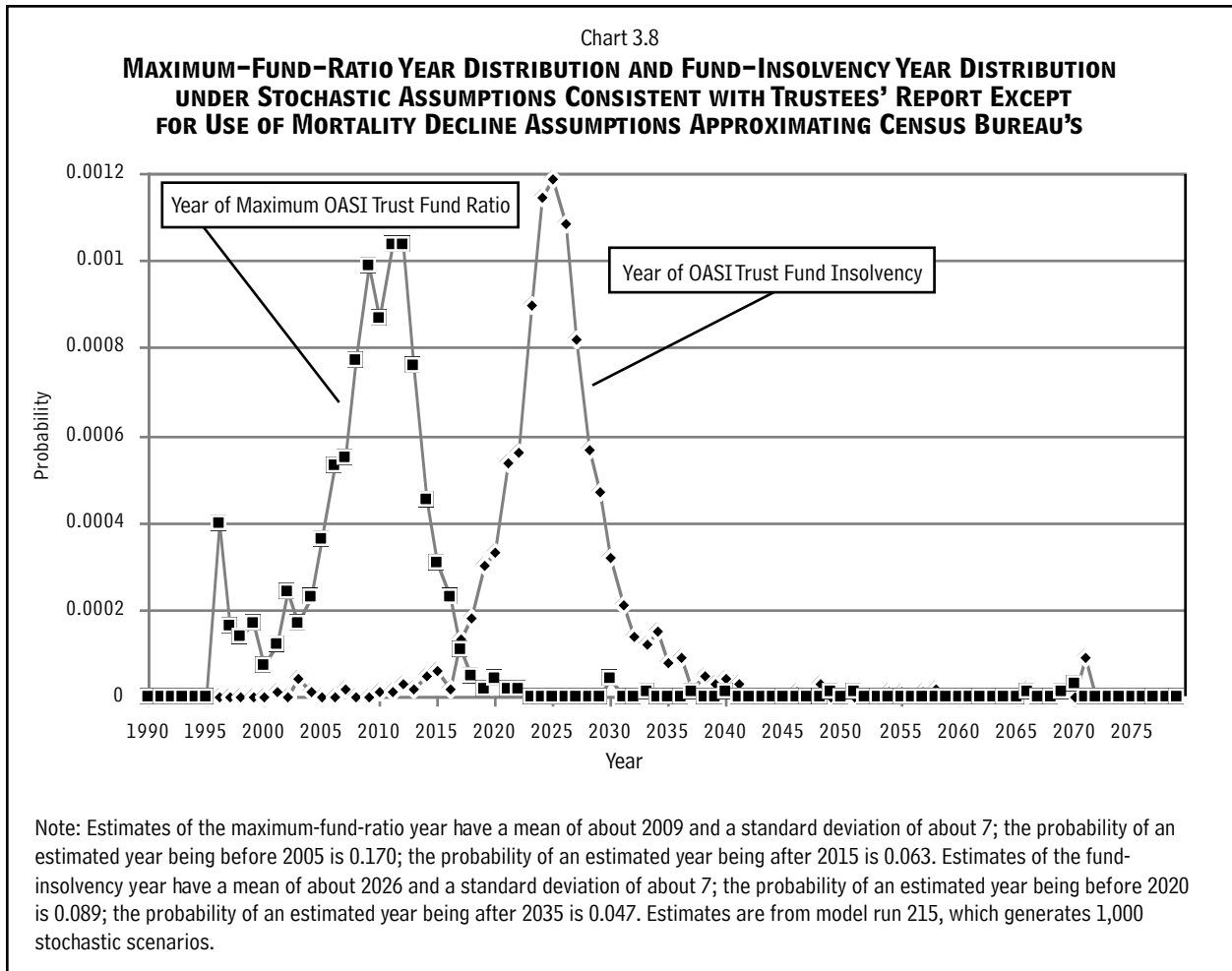
Taxable payroll was about \$2,920 billion in 1995. This means that 1 percent of taxable payroll is about \$29 billion in 1995. It also means that a deficit of 7 percent, which is the mean 2070 OASI deficit using the Census mortality assumptions along with other Trustees' Report assumptions, is equivalent to \$203 billion. This dollar deficit compares with a federal government deficit of about \$164 billion in 1995.

The size of the problem is large from other perspectives as well. The Social Security deficit estimates can be translated directly into payroll tax increases, which directly increase overall marginal tax rates for most workers. The size of the Social Security cost problem, along with the Medicare cost problem, is large enough to produce a reversal in economic growth sometime in the first half of the next century if neither problem is solved.²

The timing of the Social Security cost problem is conventionally measured by two milestones: the year the trust fund ratio reaches its peak value (which is closely related to the year during which the current annual Social Security surplus turns into a deficit) and the year during which the trust fund balance reaches zero (which is the year of fund insolvency).

The maximum OASI trust fund ratio will be reached most likely during the decade between 2005 and 2015, with the chances of a later year being only about 6 percent. After that time the fund will begin to run a deficit and need to sell (not buy) Treasury bonds to finance costs. The median estimate of 2010 compares with an intermediate-cost estimate of 2012 reported in the 1996 Trustees' Report. See chart 3.8 for the distribution of the maximum-fund-ratio year under assumptions

² See the analysis of the economic feedback effects of the deficit financing of rising Social Security and Medicare costs in "The Long-Term Budget Outlook," in *The Economic and Budget Outlook: Fiscal Years 1997–2006* (Washington, DC: Congressional Budget Office, 1996).



consistent with Trustees' Report assumptions except for use of the Census Bureau mortality assumptions.

OASI trust fund insolvency will occur most likely between 2020 and 2035, with the chances of a later year being only about 5 percent. The median estimate of 2025 compares with an intermediate-cost estimate of 2031 reported in the 1996 Trustees' Report. See chart 3.8 for the distribution of the fund-insolvency year under assumptions consistent with Trustees' Report assumptions except for the use of Census Bureau mortality assumptions.

■ Examining Alternative Solutions

The previous section examined the nature of the Social Security cost problem. This section examines the benefit, cost, and risk effects of alternative approaches to solving the cost problem.

In this preliminary examination the focus is on generic solutions rather than detailed reforms

that have actually been proposed in the public debate. The analysis of generic solutions will make it easier to identify the relative strengths and weaknesses of widely differing approaches to solving the cost problem. This comparative analysis may also suggest ways to specify more finely crafted reform proposals that would ameliorate any weaknesses identified in the generic solutions.

The range of possible nonstructural solutions is bracketed by considering two generic approaches to reforming Social Security that leave Old Age Insurance (OAI) as a pure defined benefit program. The first generic reform leaves OASI benefit policy unchanged and calls for a payroll tax rate that gradually rises in future years to levels needed to finance benefits on a pay-as-you-go basis. This current-law benefits and increased taxes approach is referred to in this section as the CBIT reform.

The second generic solution leaves OASI payroll tax rates at their current-law level and gradually reduces benefits in future years to levels

that can be financed by taxes on a pay-as-you-go basis. This reduced benefits and current-law taxes approach is referred to in this section as the RBCT reform. These two solutions span the range of nonstructural reforms that maintain the defined benefit nature of Social Security and solve the program's cost problem.

Structural reform of Social Security is represented by the third generic solution examined in this section. This approach to reform calls for establishment of defined contribution (DC) style personal retirement accounts with mandatory contributions equal to 5 percent of taxable payroll and the gradual scaling back of the defined benefit (DB) portion of OAI. This reduction of the DB portion of OAI is specified so that DB benefits decline gradually over the 1999–2040 period as birth cohorts retire having increasingly more years to accumulate account balances. During this period, the current payroll tax is maintained to finance the transition cost from a pay-as-you-go program. During this transition period, current-law tax rates are maintained in addition to the 5 percent account contribution rate. Beginning in 2040, the payroll tax is reduced so that the combined mandatory account contribution rate and reduced payroll tax rate equals the current-law payroll tax rate.

This generic structural solution changes OAI from a pure defined benefit program to a mixed DC-DB program that relies heavily on the DC account to supply Social Security retirement benefits. This approach is referred to in this section as the IARB reform because its main feature is to introduce accounts and reduce DB benefits.

It is important to emphasize that the generic reform analysis presented below is preliminary in several ways. First, the reforms are quite stylized because project time has been devoted primarily to developing the model's analysis capabilities rather than to specifying more detailed proposals, and also because it was felt that generic reforms are appropriate for an initial comparison of widely differing approaches to solving the Social Security cost problem. Second, it is possible that these preliminary results may be revised as analysts gain more experience with the enhanced model. Third, some results (such as the economic feedback effects of reforms on the rate of national saving, investment, productivity growth, and real wage growth) will not be available until after the next phase of model development.

Current Benefits and Increased Taxes (CBIT)

CBIT generic reform maintains current-law OASI benefit policy and gradually increases the OASI payroll tax to maintain pay-as-you-go financing of the program. The OASI payroll tax rate remains at 10.6 percent through 2024, rises to 13.7 percent during 2025–2029, moves to 14.6 percent for the two decades between 2030 and 2049, rises to 16.0 percent for 2050–2059, and then remains at 16.4 percent beginning in 2060. The long-term rise from 10.6 percent to 16.4 percent represents a tax increase of nearly 55 percent.

Scheduled tax increases have been designed under single-scenario assumptions that combine the Trustees' Report's intermediate-cost assumptions with the Census Bureau's mid-range mortality assumption. In that scenario, the tax schedule produces a near zero estimate for both the long-run actuarial deficit and the actuarial deficit in 2070. As shown in table 3.5, in results that explicitly recognize demographic and economic uncertainty, these higher tax rates have only about a 25 percent chance of financing the program's long-run costs. On average, the long-run deficit will be about two-thirds of 1 percent, but it has a substantial chance of exceeding 1 percent. Variability in the 2070 actuarial deficit is even larger, as would be expected.

Selected cohort effects of the CBIT reform are shown in table 3.6. The two lifetime measures of program payback—the ratio of present value of benefits to the present value of contributions and the internal rate of return (the present value discount rate that equates the present value of benefits and contributions)—indicate that the 1976 birth cohort fares relatively well. But remember that much of the ultimate rise in the tax rates is scheduled for the years after this cohort retires. Younger birth cohorts would have lower payback ratios and rates of return. Replacement rates vary little across the scenarios. The low benefit avoidance rate—the fraction of retirement years during which the average benefit across all male cohort members falls above \$5,000 per year in 1993 dollars (or \$417 per month)—is 100 percent.

Reduced Benefits and Current Taxes (RBCT)

RBCT generic reform maintains current-law OASI tax rates and gradually decreases OASI benefits to maintain pay-as-you-go financing of the program.

Table 3.5
EFFECTS OF GENERIC REFORMS ON OASI PROGRAM AND ON ECONOMY

Label	Mean	10th Percentile	25th Percentile	75th Percentile	90th Percentile
Long-Run Cost Rate for DB Benefits plus DC Contributions (% of taxable payroll)					
CBIT ^a	14.61	12.81	13.61	15.58	16.41
RBCT ^b	11.85	10.72	11.18	12.43	13.02
IARB ^c	13.92	12.86	13.42	14.5	14.93
Long-Run Cost Rate for DB Benefits only (% of taxable payroll)					
CBIT ^a	14.61	12.81	13.61	15.58	16.41
RBCT ^b	11.85	10.72	11.18	12.43	13.02
IARB ^c	9.32	8.25	8.82	9.85	10.29
Long-Run Actuarial Deficit for DB Benefits only (% of taxable payroll)					
CBIT ^a	0.67	-0.66	-0.06	1.34	2.01
RBCT ^b	0.51	-0.61	-0.16	1.09	1.65
IARB ^c	-0.23	-1.04	-0.7	0.19	0.6
2070 Actuarial Deficit for DB Benefits only (as % of taxable payroll)					
CBIT ^a	1.25	-2.32	-0.81	2.88	5.46
RBCT ^b	2.11	-0.46	0.63	3.29	5.15
IARB ^c	0.26	-0.89	-0.42	0.79	1.65

Note: See text for complete description of reforms. Results are based on 1,000 stochastic scenario values. Actuarial deficit is negative of Trustees' Report's actuarial balance; long-run refers to Trustees' Report's summarized rate, which is calculated over the 75 years ending in 2070.

^aCBIT: current-law benefits and increased taxes to maintain pay-as-you-go financing of pure DB Social Security program.

^bRBCT: reduced benefits and current-law taxes to maintain pay-as-you-go financing of pure DB Social Security program.

^cIARB: introduce 5 percent personal retirement accounts and reduce DB benefits gradually and DB payroll tax by 5 percent after 40 years of paying transition cost to a more fully funded mixed DC-DB Social Security program.

The decline in benefits is represented in this reform by a gradual reduction in the generosity of the primary insurance amount (PIA) formula over the years from 1999 through 2022. The magnitude of the across-the-board reductions in 2022 leaves benefit levels 28 percent below that called for by current-law benefit policy. Current-law cost-of-living-adjustment policy has not been changed in this reform.

Scheduled benefit reductions have been designed under single-scenario assumptions that combine the Trustees' Report's intermediate-cost assumptions with the Census Bureau's mid-range mortality assumption. In that scenario, the benefit-reduction schedule produces a near zero estimate for both the long-run actuarial deficit and the actuarial deficit in 2070. As shown in table 3.5, in results that explicitly recognize demographic and economic uncertainty, these lower benefits have

only about a 30 percent chance of financing the program's long-run costs. On average, the long-run deficit will be about one-half of 1 percent, but it has a substantial chance of exceeding 1 percent. Variability in the 2070 actuarial deficit is about the same, but it averages slightly more than 2 percent. This is significant given the lower cost of the scaled-back program.

Selected cohort effects of the RBCT reform are shown in table 3.6. The two lifetime payback measures are somewhat below the corresponding CBIT reform estimates. This is because the full effect of the benefit reductions are experienced by the 1976 birth cohort when they retire in the early 2040s. The lower replacement rates vary little across the scenarios. The lower benefits are still high enough to keep cohort average benefits at levels that produce almost complete low-benefit avoidance.

Table 3.6
EFFECTS OF GENERIC REFORMS ON 1976 BIRTH COHORT

Label	Mean	10th Percentile	25th Percentile	75th Percentile	90th Percentile
Lifetime Nominal IRR on benefits and contributions for men (%)					
CBIT ^a	5.58	3.77	4.58	6.57	7.43
RBCT ^b	4.87	3.06	3.88	5.83	6.70
IARB ^c	4.90	2.78	3.60	6.00	7.36
IARB-aa ^d	4.67	2.65	3.46	5.73	6.90
IARB-ni ^e	4.81	2.72	3.63	5.83	7.17
IARB-aani ^f	4.57	2.61	3.48	5.49	6.74
Low Benefit Avoidance Rate for men (% of retirement years)					
CBIT ^a	100	100	100	100	100
RBCT ^b	100	100	100	100	100
IARB ^c	84.43	81.37	82.72	85.55	87.16
IARB-aa ^d	84.37	81.34	82.64	85.51	87.13
IARB-ni ^e	84.39	81.42	82.71	85.53	86.97
IARB-aani ^f	84.32	81.39	82.64	85.46	87.00
Lifetime Ratio of PV benefits to PV contributions for men					
CBIT ^a	0.97	0.39	0.63	1.25	1.58
RBCT ^b	0.79	0.31	0.51	1.02	1.30
IARB ^c	0.77	0.33	0.48	0.95	1.34
IARB-aa ^d	0.69	0.32	0.46	0.86	1.11
IARB-ni ^e	0.75	0.33	0.50	0.92	1.20
IARB-aani ^f	0.68	0.33	0.48	0.84	1.03
Replacement Rate for steady average male earner (%)					
CBIT ^a	46.85	43.21	44.63	48.62	51.08
RBCT ^b	33.73	31.11	32.13	35.01	36.77
IARB ^c	57.59	26.89	34.74	68.44	97.03
IARB-aa ^d	52.76	26.72	33.37	62.58	88.08
IARB-ni ^e	58.94	31.39	38.13	68.22	96.10
IARB-aani ^f	54.21	31.49	37.19	63.44	84.79

Note: See text for complete description of reforms. Results are based on 1,000 stochastic scenario values. Members of this birth cohort are now 20 years old and will be age 65 in 2041.

^aCBIT: current-law benefits and increased taxes to maintain pay-as-you-go financing of pure DB Social Security program.

^bRBCT: reduced benefits and current-law taxes to maintain pay-as-you-go financing of pure DB Social Security program.

^cIARB: introduce 5 percent personal retirement accounts and reduce DB benefits gradually and DB payroll tax by 5 percent after 40 years of paying transition cost to a more fully funded mixed DC-DB Social Security program. The basic IARB reform assumes life-cycle asset-allocation behavior and complete conversion of account balances into indexed annuities at retirement.

^dThe IARB-aa variant is the same as IARB except that a 40/60 equity/bond asset allocation is assumed at all ages.

^eThe IARB-ni variant is the same as IARB except that account balances are converted into non-indexed (rather than indexed) annuities at a lower price.

^fThe IARB-aani variant combines the two behavioral assumption changes of IARB-aa and IARB-ni.

DC Accounts and Reduced DB Benefits (IARB)

IARB generic reform introduces a 5-percent-contribution personal retirement account in 1998. Individuals are assumed to invest their account

balance using a life-cycle asset-allocation strategy that calls for investing completely in equities when young and for the equity fraction to decline gradually to 23 percent beyond age 60, with the bond fraction rising. Individuals are also assumed at

Assessing Social Security Reform Alternatives

retirement to convert all of their account balance into an indexed annuity, which is priced assuming a continuation of recent mortality decline rates and using a real rate of interest calculated with an expected rate of inflation that is a moving average of recent inflation rates.

Also, as part of the IARB reform, the defined benefit OAI program (payroll-tax financed OASI benefits first received by those age 60 or older) is gradually scaled back. The benefits are scheduled to decline gradually from 1999 to 2040, when initial OAI benefits would be reduced 70 percent below current-law levels. The OASI payroll tax, which is currently scheduled to be 10.6 percent during the next century, is scheduled to decline—but not gradually like the benefits. The combination of 5 percent account contribution rate and reduced OASI payroll tax rate would be 10.6 percent beginning in 2040. But during the first four decades of the next century, the 10.6 payroll tax rate would remain in place to finance the cost of transition from pay-as-you-go financing to more fully funded financing. During these four decades, the combined tax/contribution rate would be 15.6 percent; after 2040, the combined rate would fall back to 10.6 percent.

This simple scheme for paying the structural reform's transition cost means that those cohorts working during the first four decades of the next century will bear the cost of the transition. In particular, the 1976 birth cohort, whose members will be age 65 in 2041, will be one of the cohorts most burdened by the transition costs. Younger cohorts will experience significantly higher payback measures because their members will have more years of work after 2040, when the combined tax/contribution rate falls back to 10.6 percent.

As shown in table 3.5, in results that explicitly recognize demographic and economic uncertainty, the scaled-back DB portion of OASI experi-

ences relatively little variability in its long-run and 2070 actuarial deficit. The 5.6 percent payroll tax rate that is in effect after 2040, when the gradual benefit reductions have been completed, is sufficient to finance the pay-as-you-go DB portion of OASI with relatively little variability in the 2070 actuarial deficit.

Selected effects of the IARB reform on the 1976 birth cohort are shown in table 3.6. The two lifetime payback measures are about the same as those for the RBCT reform and somewhat below the CBIT reform. It is surprising that the IARB payback ratios are as high as they are because this cohort bears the heaviest burden of financing the reform's transition costs. That the modest payback measures are caused by the transition cost tax burden can be seen in the fact that the average replacement rate under the IARB is significantly higher than under either of the two nonstructural reforms. As expected, the replacement rate with a large DC component to Social Security experiences much greater variability. There is also less than complete avoidance of low average benefit levels.

Cohort effects of three variants of the IARB reform are also shown in table 3.6. The nature of the alternative assumptions concerning individual account behavior is described on table 3.6. The age-inflexible 40/60 equity/bond asset-allocation variant (IARB-aa) has estimated cohort performance measures that are less desirable than those estimated for the life-cycle asset-allocation behavior assumption (IARB). The mean payback ratio falls from about 0.77 percent to 0.69 percent, and the mean replacement rate declines from about 58 percent to 53 percent. These differences are rooted in the fact that the life-cycle asset-allocation behavior produces balance-weighted account rates of return that average about 0.8 percent above those for the age-inflexible 40/60 equity/bond asset-allocation variant.

4

Comments on the EBRI-SSASIM2 Model as of January 1997

by Steve Goss

■ Introduction

The Employee Benefit Research Institute's (EBRI) Social Security reform analysis model—EBRI-SSASIM2—is extremely interesting; I am looking forward to its completion for a number of reasons. Not the least of these is the number of important observations and findings that will result from studying this topic. Already, a few items have emerged from the development of this model that will be very useful to the work we do at the Office of the Actuary at the Social Security Administration (SSA). As mentioned, they have selected 13 or 14 key variables with means based on the intermediate assumptions in the Social Security's Trustees' Report,¹ and the standard deviations are set based on high-cost and low-cost assumptions to develop the stochastic model.

■ Examining the Numbers

One thing that struck me immediately in the results occurred with runs 201, 202, and 203. These model runs are not stochastic runs; they are what we might refer to as “deterministic” runs. They are contrasted with the trustees' alternatives I, II, and III, or the low-, intermediate-, and high-cost alternatives, respectively. The results are very similar, but they are not symmetric. The high-cost number is much farther from the intermediate-cost number than is the low-cost number. In contrast, the distributions of the long-run average cost rate, and the long-run actuarial deficit that came out of run 205, which is the 1,000 simulation run, are

very symmetric, unlike the trustees' three basic alternatives.

I assume that this result is related to the fact that the mean long-range actuarial deficit for the Old-Age and Survivors Insurance (OASI) program in the stochastic run 205 is 2.5 percent, while the intermediate assumption of the Trustees' Report provides a 1.85 percent long-range actuarial deficit. There is quite a large difference between these two numbers, and this difference is apparent before the change in mortality assumption to the intermediate level used by the U.S. Bureau of the Census.

I had developed an explanation for this discrepancy that seemed reasonable until I looked at the graphs related to the stochastic run 205, which include the distributions of the cost rate and the one-year actuarial deficit for the year 2070. These distributions are not symmetric. In fact, in these distributions, the values that are in the Trustees' Report for the intermediate projection are equivalent to the median, or the mode, the point where the highest level is reached on these frequency curves. That is not the case for the long-range average cost or actuarial balance in run 205. This indicates that there are possible inconsistencies in these relationships that need further study.

One conceivable explanation is that when we define the intermediate assumptions for the Trustees' Report and set these as the mean for each parameter in the kind of stochastic approach developed by Martin Holmer,² it might result in an average cost or actuarial deficit that is, in fact, different from the intermediate. That seems to be what is happening. However, this explanation

¹ *Board of Trustees, 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, DC: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1996).*

² *See Martin R. Holmer, “EBRI Social Security Reform Analysis Project Progress Report: Phases 1 and 2,” in this volume.*

appears to fail, leaving questions about precisely what is occurring because we are not getting that same result for the 2070 values. There appears to be an inconsistency.

■ Mortality Improvement and Fertility Rates

Mortality improvement is one of the integral assumptions that the Trustees develop each year for the Trustees' Report. A few years ago, the Bureau of Census developed mortality projections different from those used at the SSA. We at the Office of the Actuary believe that the assumptions used for the Trustees' Reports are reasonable and appropriate. I would point to a couple of items to explain our reasoning.

First, the numbers discussed by Martin Homer³ indicate that if the intermediate Census numbers were used, the average stochastic long-range deficit for the Old-Age and Survivors Insurance (OASI) program would increase by about 0.7 percent of payroll, from about 2.5 percent up to 3.2 percent. The Trustees' Report provides sensitivity analysis using high-cost mortality assumptions with everything else on the intermediate basis. In this case we get about a 0.8 percent differential for the Old-Age, Survivors and Disability Insurance (OASDI) program. So there is attention to uncertainty and variation in the Trustees' Report. However, there is an important observation to be made here. The Advisory Council's Technical Panel, where the stochastic approach under discussion was developed as it relates to Social Security, also considered mortality.

The panel's best guess about future mortality would be to follow the approach used by Ronald Lee and Lawrence Carter in their September 1992 article in the *Journal of the American Statistical Association*. When we used that approach as an assumption for the ultimate rates of improvement in mortality, it resulted in a worsening of long-range OASDI actuarial deficit by 0.25 percent of payroll. This was smaller than we had expected. The approach used by Lee and Carter essentially would take the average annual rates of improvement in mortality by age and sex so far this century

and extrapolate them into the future. When that is done, the largest differences from what we are using in the Trustees' Report occur at young ages before entrance into the work force. Thus, when we applied the Lee and Carter method for mortality rate improvement at these very young ages, we end up with very large rates of improvement. You might then ask, "What is the implication for Social Security funding of having very rapid improvement in mortality at young ages?"

As far as Social Security is concerned, very rapid improvement in mortality for the young is equivalent to having more births in the population. The reason is that more people will survive up to the age at which they will be contributing to the system and having children. It ends up having a positive effect. That is why we had only about a negative 0.25 percent overall effect on the actuarial balance as a result of testing the Advisory Council Technical Panel's approach to mortality.

The Technical Panel suggested another demographic change, that of raising the fertility rate. Purely by coincidence, the magnitude of the effect of that change happens to be the same as the effect of their suggestion on mortality—but in the opposite direction. Consequently, the two canceled each other in terms of the effect on the overall actuarial balance.

That, however, is not the end of the story. Lower mortality rates and higher fertility rates would have implications for some of the policy quantitative measures with which we have been working and that the model presents. As discussed, putting together the Technical Panel's ideas about mortality and fertility would have essentially no effect on the long-range OASDI actuarial deficit; however, it would increase the money's worth ratio and the internal rates of return on a defined benefit plan. Of course, the reason for this is that longer life expectancy under a defined benefit plan results in receiving the benefit for more years.

The other observation is that the replacement rate would of course be lower under the defined contribution plans as a result of using the assumptions of the Technical Panel. Longer life expectancy means that if you have accumulated a certain amount of money in the defined contribution account as of retirement age, you will have to spread it over more years. So the replacement rates would drop.

³ *Ibid.*

■ Effects of Simplification

There are a number of caveats in terms of the present-law simulation developed by the EBRI model. Some relate to the compromises and simplifications that are required to develop a new model. Another occurs in the development of the average benefit level. As you project into the future, under steady circumstances you can roughly assume that the benefit level for the current Social Security system has a specific relationship to the average earnings level, particularly the average earnings level at the point in time when a worker retires. That is essentially the way that EBRI's model is operating at this point. However, there are some potential problems with that simplification because one of the stochastic variables is the participation rate in the labor force.

For example, if in one of your runs the participation rate in the labor force turns out to be significantly lower than it is under the average run, workers will have more “holes” in their earnings’ histories. Therefore, the relationship between their final earnings level and their benefit level would be different from that of the average case. Their average earnings over their lifetimes will be lower relative to the final earnings level. This is an example of the kind of relationships you discover when you develop any model, and it also invites further discussion of what needs to be studied and developed.

■ Developing Policy Alternatives

As you consider the alternative solutions to the long-range OASDI financing problem presented in this report, remember that the “average” deficit that is being generated under this stochastic model is 2.5 percent of payroll, versus the 1.85 percent long-range deficit for the OASI program in the Trustees’ Report. This clearly would have implications for the design of your solution if you were designing your solution based on this model. Note, also, that the model as presented pertains only to the OASI program. Including disability is crucial. The Advisory Council plans, for example, and many other plans under discussion, have very different effects on Disability Insurance (DI) benefits. It is essential to have a whole range of benefits that are considered under the OASDI plan.

■ Macroeconomic Implications

The macroeconomic component planned for the EBRI model is not operational at this point, and therefore we cannot comment on it. Many other models, including the model that we use at the SSA, do include some built-in macroeconomic feedback, particularly when we model changes in the normal retirement age and related proposals. Our structure models behavioral changes in the labor force, which would feed through into the economy. Many other macroeconomic effects that could be expected to have impact are not included at this point. This presents a real challenge for the modeling community as a whole.

■ Policy Performance Measures

The policy performance measures described in this report are familiar to many of us who have been working in this area. As described, there are two basic measures. One is related to the average of all single workers; the other is related to the stylized individual. The stylized individuals are more similar to the hypothetical workers for which we develop analysis at the SSA. Stylized individuals are those for whom you specify an earnings level and a marital status.

Under the stochastic model discussed, you must specify three things for the stylized individuals. One is the relative earnings level for the workers over their career lifetime; another is the specific age at retirement; and the third is age at death. Specifying the age at death is a very interesting adaptation of what has been done in the past. In our work and in the work of most other entities that have used money’s worth ratios, age at death is specified in a more distributional way. This allows the age at death to vary. Here it actually would be specified. Therefore, these stylized individuals end up answering different questions than those asked in the analysis for Social Security hypothetical workers.

When you allow age at death to vary across the whole possible distribution, you end up with the expected money’s worth ratio or the expected rate of return. Under this stochastic model, if you actually specify age at death, you get the rate of return and money’s worth ratio assuming that specific age at death. We have not pursued that

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specification because you cannot anticipate the age at death. We have assumed that most people, not knowing even the average, or expected, age at death, would prefer analysis on a distributional basis. However, this “stylized” approach does answer a different question than has been addressed previously, and I believe there is real value in that discussion.

The policy measures for the stylized individuals are based only on single workers, and, at this point they exclude disability and survivor benefits. With respect to money’s worth ratios and internal rates of return, it is important to make further changes as this model progresses. It will be very important to ensure that the disability and survivor components of benefits under the system are included. In addition, the model’s stylized individuals have a salary scale, as opposed to a flat wage-indexed earnings level. That will make a difference when comparing policy alternatives and provides a genuine contribution to the discussion.

■ Conclusion

In conclusion, this model provides positive information that will be useful in the further development of our work. Yet there are some questions that point to the need for further work to develop this model.

One is the specification of specific legislative options. These must be precise if you are going to try to use this model to determine the way a particular option would operate relative to current law. There may not be as much precision in the option specification of this model as we would like at this point. Attention also should be paid to the DI and survivor benefits to make sure those are fully represented. There also are some questions on some of the policy variables about single-only workers versus married workers and those with children.

My final observation concerns the expectation that the completed stochastic model will be operational on any desktop personal computer and that analysis would be attained by punching a few keys to select a few parameters. I do not know if that will be the result. My suspicion is that the detail required to get as far as Martin Holmer has in modeling—along with the detail we have experienced in modeling at the SSA—does not suggest that. Another problem occurs when you try to model new options that arise from time to time. These new options often require going back and reprogramming because we cannot anticipate every possible model option. I suspect that the evolution of the EBRI model will be similar.

5

Social Security Reform: Beyond the Models

by Marilyn Moon

■ Introduction

I want to step back and take a broad view of the question of how a model like the Employee Benefit Research Institute's (EBRI) SSASIM2 Policy Simulation Model can play a role in policy discussion. It is important to understand the limitations of these models. Ultimately, what we want to do is find ways to understand the implications of various options and then to explain them to people in ways that are meaningful to a broad policy audience. Sometimes models turn out to be the tools that analysts use in making broad generalizations beyond what is justified by the analysis. Thus it is important not to get so enticed by the apparent objectivity of modeling exercises that we forget that someone is interpreting the results.

We have come to a very important point in the analysis of public policy surrounding Social Security in which the complexity of the proposals often outstrips our ability to carefully analyze them. EBRI's model is seeking to expand our ability to look at new issues. In particular, data on the uncertainty and the risk involved in proposals with varying amounts of "privatization" should make a real contribution. Differences in risk represent a crucial aspect of understanding differences between plans that invest in the stock market and the traditional Social Security program. But all models face many challenges in this complex environment.

First, incremental changes are easier to discuss. By considering one aspect at a time, for example, it is easier to see potential impacts. However, many of the new Social Security reform proposals now being discussed would change many elements at once. This makes it difficult to disentangle various elements and understand their separate implications. What are the separate impacts of establishing private accounts in the Social Security system and of changes in the degree

of redistribution that will occur across workers? These issues are clearly interrelated, although they raise different points and they can be combined in different ways across proposals. This introduces the additional question of how, then, to find ways to use models to separate out these different dimensions.

It is also difficult to find ways to talk about concepts that Americans don't understand well, whether or not they are included in models. In particular, risk is a difficult concept. The trade-off between higher returns and higher risks is not grasped by many. Let me illustrate with an anecdote in terms of my own family. My sisters-in-law, anticipating an inheritance down the way, are very concerned about my mother-in-law's choice of a manager for her funds. Since a bank is managing her assets, they think that the bank can guarantee the principal and get a guaranteed 15 percent to 20 percent return. They don't understand that it might not work that way over time. Their expectations have been shaped by the current market.

It is difficult to explain to people, when they hear the magic words "high returns"—particularly when the Dow is around 7000—that there is uncertainty that such high returns will always be there or that everyone will get them.

The challenge then is to find new ways to analyze and interpret findings as well as to run the models. My caution today is that we not be too charmed with the elegance of the models and we opt for utilitarian approaches whenever possible. That means you have to make very tough choices about which things you want to add to a model and which new factors you build in.

■ Assumptions and Projections

As a first step, it's very important that we understand the current system and the future projec

tions. As Martin Holmer¹ said, the assumptions used in the Social Security trustees' report serve as the basis for this model, with a few exceptions. These assumptions matter, and they are very difficult to develop. Setting them each year is clearly the source of a great deal of angst and hand-wringing by the trustees and the actuaries.

I would only add that it is instructive to look back 75 years in considering how difficult it is to make future projections. Should we use all that past experience in projecting forward? Does recent experience count more than experience in 1925? For example, productivity has been quite low in the last 20 years, while a longer look back would give higher average productivity figures. How stable will the future be?

In the case of mortality assumptions, it is now fashionable among demographers to look back in time over a full 75 years and then project the same experience forward. This results in an assumption that women will continue to outpace men in terms of their life expectancy indefinitely, although recent experience indicates that this is not what is happening. These are just two pieces of the puzzle when you are trying to figure out what to say about will happen 75 years into the future.

It is important for all of us to understand that projections and modeling the future are interesting and important exercises, but these are exercises. We all know—those of us who engage in this—that we are going to be wrong. We just don't know how we are going to be wrong.

■ Issues to Consider

Now let me mention a number of issues that should be included in the discussion about options for

¹ See Martin R. Holmer, "EBRI Social Security Reform Analysis Project Progress Report: Phases 1 and 2," in this volume.

Social Security reform, only some of which can be modeled. First, would splitting the Social Security program into a system of private accounts and a basic fundamental guarantee be viewed as solving the problem? Will it help raise additional national savings and encourage people to save more for retirement?

A second and related issue is whether it will be irresistible, under a privatized system, to allow people to dip into their personal accounts for other reasons such as buying homes or paying for education and medical expenses. These are very popular proposals now with individual retirement accounts (IRAs), and this will also have implications in terms of long-run modeling of various options.

Third, how will we deal with vulnerable populations and redistribution? The issue of the treatment of dependents and survivors is critical to answer this question and one that should be added to the model. But the debate that will occur over privatization will sometimes be dominated by the argument that, "This is my account and it is my money and I'm not sharing it," as opposed to other more objective measures of the advantages and disadvantages. This is an element of the debate that will not be addressed at all by the models. This is a very subjective and important judgment that is going to be made in the policy discussion.

■ Conclusion

In sum, there is a whole range of crucial questions that models, no matter how sophisticated, cannot answer. We need to find the right balance between a sophisticated model that we think addresses the right issues and the crucial decisions that people will need to make without benefit of models. We have to be careful about the arrogance of the infallibility of models when we know that some vital questions are being left out.

6

The Importance of Systematic Analysis

by William Beeman

■ Introduction

In working on a policy statement about Social Security reform, the trustees of the Committee for Economic Development (CED) identified two major issues that they believe must be addressed: the fiscal imbalance of, and the declining return on, Social Security contributions. When you look at these two issues, you discover that a great deal of systematic analysis is required to merely describe them; even more sophisticated analysis is necessary to prescribe policies to deal with them. For that reason, the Employee Benefit Research Institute's (EBRI) sponsorship of the work of the Policy Simulation Group is important. The model simulations may turn out to be wrong; almost certainly they will be wrong. Their value, however, is that they force us to think systematically about policy options.

As one might expect, there is a great deal of careless talk about policy options; I run into it constantly. For example, when people discovered that CED was going to work on Social Security, many of them came to my office to lobby for a particular viewpoint. When I asked them fundamental questions about their position on reform, I discovered that many had not subjected their plan to any systematic analysis. The extreme case occurred last fall when I asked an advocate of privatization the fundamental question, "What do you propose with regard to transition costs in your proposal?" I was amazed that he did not know about the concept of transition costs arising from privatization. I spoke to others who were very sophisticated about the concepts, but they have a real need for this kind of analytic model to help them quantify their proposals. The projections, produced both by the Social Security Administration (SSA), including the information compiled for the Advisory Council, and, I presume, eventually by this model, and their policy analysis are fundamen-

tal to any kind of serious evaluation of major changes in policy.

■ Examining the Baseline Projections

Originally, I intended to discuss the model itself, but the details of the model are not available yet. It is hard to evaluate a model on the basis of a few simulations. Nevertheless, there are a number of interesting aspects of the model's baseline projections. For example, a lot of people talk about the problems of Social Security being far in the future. But if the model simulations are correct, those turning age 65 when the trust funds are depleted are now about 35 years old. And looking at the range of probabilities, they might be 40 years old at the moment. The point is that the fiscal imbalance is not some abstract thing that should be of no interest to most people. For those who find the projections too abstract, I like to place them in a more personal context. I note, for example, that my daughter will be 56 years old when the funds are depleted and my grandson will be 30. My "cohorts" will be dead. Actually, a few may survive (I would have to live to age 95), but most of those will have few remaining assets and will be totally dependent upon Social Security at a time when, at least according to the projections, the SSA revenues would finance only about 70 percent of benefits.

■ Handling Risk and Uncertainty

The most interesting aspect of these model simulations, the one I find most intriguing, is the treatment of risk and uncertainty. It forces us to think about the range of likely outcomes and about designing reforms that can accommodate unexpected developments. CED's analysis of policy options, published in February 1996, was deeply

influenced by the level of uncertainty. Unfortunately, I did not have Monte Carlo simulations to present to our trustees, but we discussed uncertainty a great deal, and the design of reforms proposed by CED reflects this uncertainty.

The reforms proposed by CED handle uncertainty about future revenues and costs in two ways: First, the statement endorses change that would permit the system to compensate automatically for projection errors; second, it proposes changes (mostly a reduction in the growth of benefits) that would do more than merely eliminate the projected actuarial deficiency. In this way, if the projections turn out to be correct, it would be possible to halt the phase-in of further changes in the system. If CED's proposals were adopted, it would be unlikely that we would need to address the fiscal imbalance in Social Security in another 13 years.

When completed, the Monte Carlo experiments should be very useful in the debate about the design of reform; however, in the past such analysis has prompted me to consider issues such as what happens if events fall outside these ranges. For example, a news magazine recently reported that scientists are becoming very interested in the fundamental determinants of life span. One story announced that scientists now know how to increase the life span of fruit flies by 50 percent and that they are extending their studies to other kinds of creatures. If this work has implications for humans, we will need a different type of recommendation for the SSA. Perhaps it should pay these scientists to drop their research. Alternatively, the trustees could ask the scientists to research the following question: How do you induce fruit flies to delay retirement? Or perhaps they can identify the gene that makes rats stay in the rat race longer.

■ Conclusions

I urge the model builders to continue their work and to progress to the macroeconomic issues because, in my judgment, one of the most impor-

tant criteria for evaluating reform proposals is the effect on national saving. Speaking only for myself, I would not endorse a reform proposal that did not at least have a very good chance of significantly raising national saving.

I also believe that one should proceed with great care in using data both from these models and from calculations by the SSA. For example, the EBRI model discusses money's worth ratios by cohorts. The pay-as-you-go option predicts that young workers should worry a great deal about Social Security, and they are worrying about it. And it says that the outlook is worse for their children. As you know, with the pay-as-you-go option, tax increases are postponed until they are necessary; in effect, the tax burden is passed on to young workers, creating lower returns for each new generation.

The rate of return analysis is another critical consideration. On the other hand, is it really valuable to compare reform proposals using this analysis? Suppose you wanted to create a reform proposal that showed a very high rate of return. What would you do? The answer is (1) look for financing outside the Social Security system, or (2) delay tax increases as long as possible. If one were an extremist on the return issue, I would say, "Well, lower the payroll tax and increase the federal deficit to pay for it until we get the rate of return on contributions rising in the projections." It is important to remember the sources of differences in these projections. Some plans, for example, do have deficits; they finance the transition through deficits. Such proposals are likely to increase the rate of return within Social Security and decrease it for the economy as a whole. So, it requires a great deal of skill and thought about the use of the various kinds of analysis provided by the simulations, but they are absolutely essential. I strongly encourage EBRI to continue to support this project and I am looking forward to the macroeconomic simulations, which I view as the most important aspect of the modeling.

7

Can America Afford to Grow Old?

by Gary Burtless

■ Introduction

A few years ago, a couple of us at Brookings wrote a book about the cost and affordability of Social Security.¹ The public trustees of the Social Security Administration (SSA) commissioned our study, and we tried to be very evenhanded and scientific. We wrote soberly about the unpleasant policy choices facing the country, and we tried to show why certain policy choices might be preferable to the status quo. It would not be exactly accurate to say that important policymakers ever *read* our book. But aides to important policymakers—or perhaps the unpaid summer interns of the aides—may have done so. Of course, our book has not had a noticeable impact on public policy ... so far. The President and Congress have not followed our excellent advice, and perhaps they never will.

The title of the book, *Can America Afford to Grow Old?*, raised the question under discussion. I thought the first 20 pages of the book clearly conveyed the answer as, “Yes, we can afford to grow old.” But more than half the news articles written about the book concluded that the answer was, “No, there’s no hope. We can’t afford to grow old.” This misinterpretation of our message may reflect a common problem among journalists, who may reason that they never will see their names in print if they write a story about good, or, at least, ambiguous news.

Our message, which was fairly simple, said the opposite: “Look, the country’s population is growing older. This is clearly going to raise the percentage of the population that draws Social Security benefits in the future. But the resulting

growth in spending is manageable, about 2 percent to 3 percent of Gross Domestic Product for Social Security.” The extra spending could be financed out of growing incomes. Moreover, the amount of extra spending actually could be scaled back if the nation undertook prudent reforms before the huge increase in the number of pensioners.

We even suggested a public policy to reduce the future burden of Social Security. In particular, we could save a larger Social Security surplus. That is, the country could accumulate Social Security surpluses at a faster rate than will occur under current law in one of two ways—either by hiking the payroll tax or reducing promised benefits in the near future. At the same time, it could reduce or eliminate the deficit in other government programs. That combination of policies would increase government saving and, in turn, raise the nation’s capital stock over the medium and the long terms. If national investment and saving were higher, future national output could be higher. The nation could be paying for a larger amount of public spending on the nation’s elderly, but it would pay for it out of a larger economic pie, leaving a bigger slice of that pie for future workers to consume. Thus the burden of supporting an aged population would be lessened.

It is quite plain, seven years after publication of our book, that this multidimensional policy is not about to be adopted. Congress and the President have not taken any action to accelerate the growth in the Social Security surplus, although they have sharply reduced the deficit in the remainder of the federal budget. Many believe that any attempt to expand the Social Security surplus would be futile anyway. If policies were adopted to expand the surplus, Congress and the President would simply spend the bigger surplus on other government operations, including Medicare.

¹ Henry J. Aaron, Barry P. Bosworth, and Gary Burtless, *Can America Afford to Grow Old? Paying for Social Security* (Washington, DC: The Brookings Institution, 1989).

■ Proposed Reforms

So this brings me to the recommendations of the latest Social Security Administration's Advisory Council. That council's deep division was reflected in the failure of any single proposal to gain a majority. All three plans to emerge from the Council tried to boost public or private saving, although they would attempt to accomplish this in very different ways. Thus, all three plans tried to secure some of the potential gains that we could enjoy by obtaining a higher return on the retirement system through investment in the capital market. In the present environment of slow productivity growth and slow growth in the labor force, returns in the capital market typically exceed the returns that can be obtained in a pay-as-you-go system. All three plans would slow the future rate of growth of Social Security benefits. One would increase the rate of growth of the Social Security reserve. The other two would create a new pool of private savings to finance mandatory defined contribution plans.

■ The Model

The Employee Benefit Research Institute's (EBRI) simulation model—EBRI-SSASIM2—can help us to understand the three plans. This model, a worthwhile effort that shows much promise, projects interesting results concerning the risk of adverse demographic and economic events. It demonstrates the implications of different reform plans for payroll contribution rates and cost rates and for the long-term actuarial deficit as a percentage of payroll. It shows returns and money's worth calculations under various reform plans. It also explores long-term replacement rates under alternative plans. This kind of information, as well as information about the uncertainty of these outcomes, is necessary to consider how we should attempt to reform Social Security. Some extensions of the model will be very helpful.

■ Obtaining Symmetry

In regard to examining risks, it would be useful if the modelers adopt symmetrical optimistic and pessimistic assumptions about the future. The optimistic and pessimistic assumptions should

actually reflect the recent experience of the United States. I do not think we can say that each of the assumptions of the Social Security trustees actually reflects recent experience in a symmetrical way. For a couple of assumptions, I think, the central point estimate may be more optimistic than the recent experience. In addition, even the lower bound estimate is more optimistic than I think many people would accept for a lower bound estimate of what the future may hold. So what if our modelers moved away from the trustees' assumptions and, instead, asked, "What has been the experience of the United States in the last 25 years? Now let us bound that actual experience with symmetrical optimistic and pessimistic assumptions about the future." That policy simulation would be of interest in addition to analyses they already have performed.

Second, it is crucial that the modelers account for the feedback effects of these reform plans on saving and investment and, hence, on future national income and future real wages. This extension is particularly important if we want to assess the plans that propose to increase national saving, either through privatization or through an increase in the size of the Social Security reserves. It is necessary to model the feedback effects to evaluate the primary advantage of increasing national savings in advance of the baby boom generation's retirement.

Finally, it will be useful for the authors to examine several proposed actual plans. They should evaluate not only the Advisory Council's three plans but also the plans suggested by other groups. Some plans, for example, move even further toward full privatization of the nation's retirement system.

■ The Questions for Generation X

The calculations in this paper lead to a conclusion almost anyone would reach: Partial privatization may not be a good idea for workers in Generation X. Under full or partial privatization, these people will be asked to (a) contribute to a slimmed-down, defined benefit Social Security program; (b) contribute to a new defined contribution private plan that will supplement reduced Social Security pensions; and (c) contribute a substantial percentage of their earnings to pay off the accumulated liabilities of

Social Security. These liabilities are owed to people who are nearing retirement age or retirees who already are collecting pensions. In effect, Generation X workers will be asked to pay for the retirement of two generations—their own and the generation immediately preceding them.

Let me add, however, that the burden can be lightened in two different ways. This will become plain when the modelers account for the feedback effects of higher saving on the national economy. Faster growth of the economy, faster growth of the capital stock, and faster growth of real wages would reduce the burden of old-age pensions on future generations of workers. In addition, the burden on Generation X would be lightened still further if the burden of paying for the accumulated liability were spread out over a longer time than 40 years. One idea is to impose a tax in perpetuity that pays the interest on the additional debt that the country must accumulate to pay off the current accumulated liability of Social Security. But remember, if we pay only the interest on the accumulated liability (rather than the accumulated liability itself) over the next 30 or 40 years, we will not enjoy a very big advantage from the point of view of increasing national saving. If we lighten the burden on Generation X by extending the period over which we pay off the accumulated Social Security liability, we will not boost national saving by very much over the next 30 or 40 years.

■ Cost-of-Living Calculations

Finally, let me address another important event that has implications for Social Security reform, the recent report of the Advisory Commission to Study the Consumer Price Index.² If the commission is

² *Advisory Commission to Study the Consumer Price Index, Toward a More Accurate Measure of the Cost of Living: Final Report (Washington, DC: Senate Finance Committee, December 1996).*

correct in believing the CPI overstates changes in the cost of living by an average of about 1.1 percent annually, we have all received a very good piece of news. First, we are all richer than we thought we were; compared with 40 years ago, we are 55 percent richer than we thought we were. So we are *already* better off.

Second, in the future we will be richer than we thought we were going to be. If the trustees thought real wages are going to rise by about 40 percent between now and 2035, the commission has good news for them. It now turns out that wages actually are going to rise 107 percent. One implication of this is that if the payroll tax must rise four percentage points to pay for the larger retired population in 2035, workers in 2035 will be earning 95 percent more than we do today, even taking into account that they will pay a higher payroll tax than we pay today. If this is true, I am not going to worry too much about making tough choices today. Why make consumption sacrifices today that will help these workers trim their payroll tax by a couple of percentage points? They will be twice as rich as I am. Why should I scrimp and save on their behalf?

Third, payroll taxes are not going to have to rise as fast as the trustees predict. Why? We can give less money to future retirees than is predicted in the trustees' report. We will not have to give them cost-of-living increases that are as large as the trustees assume. Instead, we might give them cost-of-living increases that average about 1.1 percent less. I hope that in future implementations of this model we will see the full implications of the commission's report. I also hope, however, that no reader of this comment will believe I am seriously proposing a cut in cost-of-living adjustments amounting to 1.1 percent a year. To make such a proposal, I would first have to be persuaded that the bias in the present consumer price index is 1.1 percentage points. I have yet to be persuaded that the bias is that large.

8

A Comment on Mortality Assumptions, Low Wealth, and the Need for More Saving

by James P. Smith

■ Introduction

I want to make a few comments at the beginning about the actual modeling exercise; in particular, about the mortality assumptions. In the present version of the model, the only thing that is really analyzed is the effect of mortality. Most of the other interesting issues have not yet been included in the simulation model. In particular, the crucial issues of the effects on savings and economic growth, which I think ought to be the main criteria on which we decide whether reform is desirable, are excluded.

■ Mortality Assumptions

There are two issues of Social Security reform concerning mortality. First, it is a very wise decision to abandon the Social Security Trust Fund's mortality assumptions and move to the Census Bureau intermediate estimates. Second, the authors also present a range of values through thousands of iterations that indicates something about the uncertainty involved with future mortality. That is a useful exercise. However, I think we have to be very cautious because the uncertainty is much wider, mostly in a pessimistic direction—pessimistic in the sense that we are going to live longer. Therefore, projections for the Social Security Trust Fund may be more pessimistic than these estimates indicate.

In an academic audience, the Trust Fund's mortality estimates would not be taken seriously as projections of future mortality declines. Even the Census Bureau estimates are viewed with some suspicion as accurate estimates of what future mortality decline estimates will be. Most of the estimates in the academic literature see much sharper declines in mortality, and, especially, the potential for much larger fractions of the population who are old. If I had to take a point estimate, I

would actually use the ones that Martin Holmer¹ mentioned—the estimates that are being done by Ron Lee at Berkeley with a series of his colleagues.

I would view Lee's work as the best point estimate of the future course of mortality. To illustrate the implications: the number of people over age 85 according to the Trust Fund estimates is 14 million; the Census intermediate estimate is 18 million, and Ron Lee and company project 21 million. I would not use the long-run cost average to determine the implication of these different mortality rates. Instead, I would use the 2070 numbers—that is the steady-state to which we are heading from different mortality estimates. The effects of using Lee's estimates on the steady state, 2070 numbers, in terms of the average cost of maintaining the current benefit structure, are much higher than the discussions at this policy forum have indicated. They would bring it up by at least another two percentage points.

Lee's estimates move the central tendency on mortality over to a higher number. We will have a range of possibilities outside that central tendency of Holmer's estimates—a different central tendency. Because of this, we have a different range of what is possible than before. As a result, Holmer's original range of estimates is not really an indication of the real uncertainty if we do not get the central tendency right.

The seriousness of this problem is indicated by the different estimates available from very reputable scientists, whom I regard as experts on mortality (in particular, Ken Manton and Jim Vaupel). Instead of the 14 million projected by the Trust Fund, they are projecting 39 million people over age 85 in the year 2050. These numbers would

¹ See Martin R. Holmer, "EBRI Social Security Reform Analysis Project Progress Report: Phases 1 and 2," in this volume.

certainly not be my point estimate. But they are much more plausible outcomes than the reverse on the other extreme, which would be no growth in the population of people over age 85 compared to the current estimates.

What we have then is a higher mean value for mortality and a very skewed distribution, where the outcomes with much sharper declines in mortality more likely than the outcomes of reversals in the mortality process. All these considerations are leading to more pessimistic estimates of the cost implications and higher average cost estimates for the Social Security program's sustainability.

■ Mortality and Socio-Economic Status

The second problem with the way these mortality numbers are being generated is that there is considerable recent research showing that mortality is very sensitive to measures of socio-economic status, such as income or wealth. Research on low-income individuals done by Lee Lillard indicates that if you take people in the bottom 10 percent and people in the top 10 percent, mortality differences are sevenfold in terms of age-specific mortality rates. Other scholars have estimates of a strong relationship of mortality to wealth. This strong relationship between mortality and measures of socio-economic status has implications for the distributional equity of the program and also for its cost.

Even though Social Security is a progressive system in terms of benefits, people with higher income still receive more benefits, and people with lower income receive fewer benefits. Decreasing mortality among those receiving more benefits, if the overall mean for mortality rates remains constant, could have a significant impact on program cost.

This relationship of socio-economic status to mortality also affects how we view Social Security in terms of its equity. Once you introduce the fact that high-income people are going to live longer than those with low income, about one-third of the Social Security progressivity is eliminated by this relation.

■ Achieving Fiscal Balance

Let me make two other points. One of the things that troubles me about this simulation exercise—not just this exercise, but all simulation models—is that fiscal balance is achieved in one of two ways. We either reduce benefits or increase taxes. All the adjustments are self-contained within the Social Security system. What we are leaving out, and what I think has to be included in the modeling exercise, is that these are not the only ways of balancing this system. In fact, this has not been the way we have been going about balancing the system in recent years.

What we have to add to this model is what the government sector is going to do. If the tax rate needed to sustain this program to the year 2070 is about 20 percent for Social Security and another 12 percent for Medicare, this is a combined tax rate of one-third on these programs. Therefore, we are moving up toward a tax burden of 40 percent on an age-related transfer from everyone below a certain age to everyone else above a certain age. In time, that is the tax level to which the current level of benefits is pulling us. We have to ask ourselves, if we maintain the current structure of benefits, what will happen to the government sector?

I think what will happen is that other government programs will be severely reduced. This policy is the same as putting Social Security off the table, exactly what we are doing now. We are putting Social Security off the table and making all cuts in other social programs, many of which are hitting low-income people very hard. If we take the position that we want to maintain an age-related set of benefits that imply a 40 percent average tax rate, we should include in the modeling exercise what the likely reaction is going to be in terms of the rest of government's expenditures. This policy does not seem progressive to me.

■ Conclusion

I will conclude with some of my own recent research on the economic status of the elderly.

Using recent data funded by the National Institute of Aging, we now have a much better idea of the financial situation of the elderly and near elderly. This financial situation covers all financial

assets, broadly defined, including checking and savings accounts and just about any financial assets you can think of. For people over age 70, those who are currently in the Social Security program, financial wealth is very unequally distributed and very small for most older households.

The big news is not that the poor did not save. The news is that the average white household over age 70 has only \$10,000 in total financial assets. If they had to rely only on their past savings, it would get them by for about half a year. Even if you examined people right before their retirement, you might think they have a lot more on hand to deal with the emergencies that might happen in their lives. However, the average white household in their 50s has financial assets of \$17,000. That is equivalent to about half a year's income. If they lost all other sources of support, they could generate half a year of income.

Any sensible and prudent Social Security reform will reduce the level of age-related benefits indefinitely into the future. However, unless people simultaneously increase the level of their private savings, we are going to have many people in very dire straits indeed.

I will close with the following argument. You cannot talk about Social Security reforms in isolation. You must also deal with encouraging saving and economic growth. My proposal is, in addition to changing the benefit structure of these programs, to introduce, immediately, a consumption tax so that we do not tax the creation of wealth, either savings or investment. I would insist that it be a progressive consumption tax. We know that most rich people favor a consumption tax not because it encourages growth, but because it is going to make them a lot of money. But we can have the economic benefits of a consumption tax and make it sufficiently progressive to eliminate legitimate equity concerns.

9

What Can We Learn from Modeling Social Security?

by Gene Steuerle

■ Introduction

Having built a few models myself, I am well aware how easy it is to comment on all of a model's limitations. During an earlier discussion I had at the Employee Benefit Research Institute (EBRI) about some of the model-building that we were doing at Urban Institute, someone said, "I thought we agreed about five years ago that some of those data are outdated and that we needed to move on to better behavioral assumptions." All of us can be a bit taken aback by comments on our models' limitations.

We are somewhat like Sisyphus, who as punishment for having engaged in a bit of trickery was required for the rest of his life to roll a ball up a hill. As soon as he got it near the top of the hill, it rolled back down again. He kept rolling it up and it would continue to roll back down. That is what I think often happens when we try to build these models. We think we're going to roll this ball up the hill and come up with the ultimate model, and then someone comes along and says, "But you didn't deal with this," and the ball goes back to the bottom of the hill.

■ Allocating Resources

Concerning Social Security, I don't think the issue is only one government program. I think we are dealing with a very broad societal issue of just where we want to go as a society and how we spend the increments of our wealth as a society. I agree with Gary Burtless¹ that we can afford an increase in those payments to the aged that are defined as Social Security. I think we can afford it *if* that is what we want to do. But we have essentially been

on a 50- or 60-year trend where tremendous portions of our increases in wealth have essentially been paid to ourselves, for consumption in old age.

We have pursued this long-term trend not only through Social Security but also through private pension systems and through Medicare. This path of growth has been at an unsustainable rate; that is, at a rate that would eventually require us to spend more than 100 percent of our income on consumption in old age. We know we have to move off that path. What makes it so difficult is that, in addition, there is also the demographic problem: a dramatic and rapid drop in the ratio of workers to retirees. The baby boomers' retirement will accelerate this phenomenon.

Recent Congressional Budget Office (CBO) projections concerning Social Security, Medicare, and Medicaid indicate that an increase of about eight to nine percentage points of Gross Domestic Product (GDP) would be required simply to pay for these programs. Two-thirds of that number represents health care benefits, and I don't think that health is something you necessarily want to leave off the plate when designing a reformed system. If we translate CBO numbers to a tax rate, our current system already has built into it a tax rate of about 33 percent, from these government programs alone. This tax rate has been built into the existing system, and now the question is how can it be cut back.

This 33 percent tax rate can be translated another way. Suppose we expect to live one-third of our lives in retirement, we have a ratio of essentially two workers per one retiree, we expect to maintain ourselves in retirement at about the same income level of income that we had before retirement, and we expect these retirement benefits to be provided by other generations. Again, this requires about a 33 percent tax rate; i.e., these two workers would have to pay about 33 percent of their income

¹ See Gary Burtless, "Can America Afford to Grow Old?" in this volume.

each simply to support the third adult who is retired.

While Social Security by itself does not have this type of replacement rate, once you start counting spousal benefits, the fact that many benefits are nontaxable, and the huge increase in health care costs—which are much higher among the aged—in fact, you do get closer to that type of replacement rate. I think this rate is largely unsustainable, not because we cannot afford it but because it is an allocation of economic reserves that does not make sense relative to other societal needs.

■ Increasing Savings

The specific plans advanced by the Social Security Advisory Council only address a small part of this problem. They mention trying to find one percentage point of GDP or, with luck, one and one-half percentage points of GDP, shifting the numbers around one way or the other and hoping that this will have an impact on the much larger problem. In the so-called maintain benefits plan, the government reallocates its portfolio and shifts the assets it buys—not necessarily increasing saving all that much.

Another plan makes more of an attempt to increase private saving, but one needs to be careful in assessing how much. This plan tries to increase saving by taking five percentage points out of the current Social Security tax rate. That is about two and one-half percentage points of GDP. Then it immediately says, “Because there are so many problems with maintaining minimum benefits, we are going to borrow the equivalent of two percentage points and have another tax increase of one and one-half percentage points,” so the net change in tax rate ends up being only about one and one-half points. Again, this is in a system in which merely to achieve balance, the equivalent of a 33 percent tax rate is promised for the future. To get that rate down to 15 percent is an enormous challenge.

■ The Work Force

I have some concerns with a lot of the model building surrounding “privatization”—even though I myself have favored some of the types of

privatization proposals. One real concern is that I don’t think enough steel mills can be built to solve the problem of the reduction in human capital. This question of building human capital into the models seems to me most difficult.

Let me put it in rather stark terms. If we were to drop immediately today to the ratio of workers to retirees that we project will occur in about 30 years, this would be equivalent to adding about an additional 10 percentage points or more to the unemployment rate. And only a miracle worker could manipulate one percentage point of a tax rate here or there and address this type of problem. There will be a tremendous drop in human capital. Measured in terms of wealth, it is on the order of trillions of dollars of decrease in our use of human resources. One thing I hope that we start building into our models is the effect of this decline in human capital and how we will cope with a much smaller labor force.

■ Retirement Age

One difficult variable to model is the statutory retirement age. Before I began to study the issue, I had always assumed that 65 was an appropriate retirement age, but I had no idea where the number came from. It is embedded not only in our public-sector laws but also in many private-sector plans as well.

What this signal tells our society, in terms of its expectations, is that we can expect to be retired for one-third of our adult lives. What happens if you change that signal? It could have enormous behavioral effects. I think that this is a vital, and probably one of the most important, issues that face us with respect to modeling changes in retirement programs.

There is a closely related issue that I don’t know how to model but consider crucial. My impression is that many executives in the private sector are quite willing to take on the issues of Social Security but are unwilling to come to grips with the issue of when to retire people within their own private plans. They say, “We will work on Social Security, but we still want to retire all these people at age 55 and 60 because we are overpaying them and cannot afford to pay them at current levels.”

■ The Impact of Government

Yet another modeling issue is how much government can affect net investment or saving. The simple model assumption that most people start with, and then modify slightly, is that if government can somehow extract an additional dollar and put it in an account somewhere—be it a government account or a private account—it has increased saving by a dollar.

This might be true in terms of a single individual, but even there one needs to be careful. Investors in financial assets have also financed a lot of borrowing on credit cards today. Secondary mortgages have also become very common. The idea that a gross deposit increase of a dollar translates into net saving increase of a dollar is misleading. When one starts thinking about models, one has to ask about these shifts.

As I understand the EBRI model as it is developing, it allows for some private-sector shifts. For instance, if one increases government-mandated private saving or private deposits by a dollar, it might have some impact on private pension deposits. If I have a mandated savings plan and contribute \$1,000, the question is how much do I then put in my 401(k)? At that point, we are not done because other shifts are also occurring.

Think of the market for loanable funds. Put another dollar in deposits. Anyone can come in that market and borrow, and many of the borrowers are not taking that money and converting it to net investment. The crucial question then becomes, how much can government actually affect net saving and investment, even if it can get an additional dollar into an account and even if it builds up the Social Security surplus?

A study I did for the Brookings Institution demonstrates that in a period when government was saving much more, especially in the early post-World War Two period, there was a tremendous increase in consumer borrowing at the same time, probably financed in part by the government's efforts. A crucial issue that we need to be able to model is how much government can affect net investment and saving. We should model alternative assumptions as well. One strong possibility is that government, no matter how much it adds to deposits in one part of its system, will increase net saving or investment only modestly.

■ Integrating Private Plans in the Models

This brings me to a related issue: the question of integrating private plans into these models. We have talked about mandating benefits, or mandating savings in various accounts, but have not discussed how this integrates with private plans and private markets. This goes beyond the issue I raised previously: If I have another dollar of savings in an account because of a government-sponsored mandate, how much have I affected saving in a 401(k) plan? There is the question of the impact on the system as a whole. Some of these choices involve legal changes, such as how discrimination rules would be remodeled, since we have to decide how much mandated savings would affect the determination of whether plans are discriminating any longer against low-income employees. Similarly, there are questions of portability, participation, and employer design of benefit and pay systems.

■ The Question of Risks

There are a variety of risks specific to the plans that have been advanced so far. One risk with the maintain benefits plan being considered by the Social Security Advisory Council is the market risk that comes from the government starting to invest this money in the stock market. Questions include what happens to bond interest rates, what happens to the bond market, and what happens if other governments start following this same logic and start investing in the stock market?

If one thinks that one can arbitrage the federal system, then why not have the federal government borrow a trillion dollars and invest in foreign markets? Maybe we will not have any budgetary problems at all, if we think we can simply arbitrage to deal with them.

In terms of the privatization, the strictest privatization plan considered by the Council involves increases in government debt. My understanding is that the nominal debt increases by about \$2 trillion at its maximum, or \$650 billion in present value terms. This approach would have effects on the markets that need to be taken into account.

There is a government risk in this plan as

well. There is a \$410 basic benefit. That is about two-thirds of the poverty level, as I understand it. If the money in these private accounts does not succeed in generating much in the way of return, or individuals invest poorly, there is a high risk that government will have to supplement this basic benefit.

■ Conclusion

I think the type of modeling that EBRI is doing will be useful in a number of ways. In some cases, it will identify risk better than we have been able to do before. In the identification of risk it is not always important that we get our estimates right; whether they are right or not, the models often tell us how to redesign reforms in ways to modify these risks.

For instance, if our risks are very sensitive to

life-expectancy—and I think they are—it is not so hard to think of a reform design that indexes the age of retirement for life expectancy. What this model tells us, regardless of whether the numbers are precise or not, is that a risk is present. If it appears to be large, we can think about remodeling Social Security to deal with it.

Another example concerns individual investment. If some people invest poorly, with little to show from their private accounts, and also have basic benefits that are well below poverty, government would have to back up a reformed Social Security with a large welfare program. The model, therefore, warns us that we need to start examining ways of regulating returns in a privatized system. Chile is often given as an example of a successful privatization system, but Chile greatly regulates minimum returns on privatized accounts.

10

Issues Concerning the Model

by Robert Shapiro

■ Introduction

First, I want to salute the Employee Benefit Research Institute (EBRI) and Dallas Salisbury for their splendid commitment to developing a new model that can evaluate the effects of various approaches to Social Security reform. It is a serious effort, responsive to the needs of both the policy community and the political decision makers they advise, and it will be of inestimable value for developing Social Security policy and fostering informed political debate about it.

I would like to pass over the technical issues concerning the model. These issues are of serious interest to econometricians and other academic specialists, but Social Security reform is not an academic exercise. It is a political enterprise that will touch virtually every American. Consequently, I would like to raise a few issues concerning, if you will, the model's conceptual base line; that is, issues that will help form the political predicate for the debate over Social Security reform.

■ The Economy

The first issue concerns our efforts to project the effects of various reforms on the economy. Structural reform of Social Security raises economic questions about not only the impact of the funding shortfalls expected under the current arrangements but also these arrangements' other effects on capital formation and other basic elements of the economy. The model should try to take account of these dynamics. Let me restate this point more concretely. The model should enable us to evaluate the effects on the economy of the current system as well as of various reforms. In this way, we can more fully understand the likely impact of various reforms by evaluating them relative to not only the current system but also to the economy, apart from the current system.

■ Trust Fund Assets

The second issue I would like to raise concerns how the model will treat Social Security trust fund assets in evaluating the implications of both the current system with its expected financing shortfall and various approaches to reform.

One of the strengths of the EBRI project is its commitment to address Social Security reform not only from the perspective of the system itself but also in the larger context of overall government spending and revenue collections and from the larger vantage of the Social Security system's place in the economy. These are the very considerations that have led many reform advocates to propose some element of prefunding or higher current saving in addressing the system's coming funding shortfall.

Prefunding part of future liabilities was also an essential element of the 1983 Social Security reforms. Yet, I believe most of us could agree that the prefunding that has occurred under those reforms is of a very peculiar sort, from the larger perspectives of the entire government and the economy. From these vantages, the resources represented by the trust fund balances have not been saved in the ways that are conventionally recognized by economics or accountancy. The securities held by the trust fund represent an economic asset for the Social Security Administration but a corresponding economic liability for the rest of government—and one that will entail additional revenues, spending reductions, or borrowing of precisely the same kind and extent as would be required if there were no trust fund. The trust fund's assets also represent a corresponding liability for the economy, because the surplus revenues they represent have been used not to increase the capital stock but only to finance government activities.

We cannot sensibly evaluate the economic implications of reform if we do not acknowledge that financing based on these trust fund assets, as currently planned for the years 2013 to 2030, will involve additional borrowing, spending reductions, or tax increases equal to the face value of these assets.

Yet, in most current discussions, and in the Advisory Council's three reform proposals, the economic value of these trust fund assets is simply assumed. I urge EBRI to address the trust fund issue independently and to incorporate the economic implications in its model.

■ Modeling Future Performance

Third, I would like to raise the issue of our ability to sensibly model the future performance of financial asset and debt markets over substantial periods, as would seem to be required in order to evaluate the implications of various proposals for partial privatization or government investment in private asset markets. It is the nature of these markets that they capitalize countless unanticipated economic events and developments, so that in order to project their future performance we would have to be able to anticipate the equilibrium effects of such events and developments. Yet, if they could be anticipated, it would disable these markets.

At a concrete level, try to imagine, if you can, what a model of our equity and debt markets constructed in the 1960s would have projected for the 1970s, 1980s, and 1990s, relative to the actual performance of these markets.

More particularly, I am concerned about the applicability of whatever conclusions are arrived at, concerning future average market rates of return, to periods of a few decades and to different classes of investors. These markets have demonstrated enormous variation in rates of return from year to year, and these variations if continued would have enormous effects on the resources available to different cohorts of retirees under any form of privatization. Robert Shiller at Yale, for example, has documented 15 years in the last 70, including seven years in the 1970s and 1980s, in which the

inflation-adjusted value of the Standard & Poors 500 Index was at least 40 percent lower than it had been 10 years previously.

These markets also display enormous variations in rates of return among different investors and classes of investors. There have been two studies of these variations, and both suggest that investors' rates of return are generally associated with income. In particular, high-income investors report rates of return roughly three times as great as those reported by moderate-income investors, so that high-income people earn higher than average rates of return and moderate-income people earn lower than average rates of return. I seriously question, therefore, the usefulness of *any* assumption about a future average market rate of return for evaluating the social implications of privatization reform proposals.

At a minimum, the model should take account of the problematic character of our ability to project with any confidence the impact of private investment over periods of time and among different groups of investors.

■ Conclusion

Finally, I want to suggest an additional dimension for the EBRI project, expanding its conceptual base line. One of the project's intriguing elements is its commitment to provide a means of evaluating the normative implications of various reform proposals, with respect to both the distribution of benefits and taxes, and the political character of the new arrangements they would entail. Given this ambition, the project could benefit from a systematic evaluation of public opinion, probing people's responses to various alternatives and their implications. By documenting the schedule of values which the public holds in these areas, the project could enrich the debate about the normative implications of the various reforms.

In closing, once again I want to salute EBRI and its project. I hope that by raising certain conceptual issues, I have provided a small contribution to this splendid and important effort.

11

Social Security Reform: Gaps in Perception

by Susan Dentzer

■ Introduction

The Advisory Commission to Study the Consumer Price Index (CPI), headed by Stanford economist Michael Boskin says that the overstatement implicit in the CPI is about 1.1 percentage points a year. The commission further suggests that fully more than one-half of this overstatement is due to the fact that the CPI is incapable of adjusting adequately for changes in the quality of goods, and in particular the quality of new products. An estimated .6 percentage points of that 1.1 percentage points of overstatement is attributed to this phenomenon.

However, consider how the commission reached this conclusion. For example, it sampled 27 categories of goods in the CPI. It concluded that there was not much of a bias to speak of in 7 of the 27 categories, and there was substantial upward bias in the other 20. The commission concluded that apparel has actually been improving markedly in quality and that, as of about 1985 onward, the overstatement of the inflation in the apparel sector of the CPI has been one percentage point per year.

As a person who has occasionally done some shopping, the overwhelming impression I do *not* have when I shop is that the quality of apparel is improving by 1 percent a year relative to the price.

You get a sense, as one of the commission members said, that the precision of these numbers is not to be taken to the third decimal point. It is going to be a very long process as the Bureau of Labor Statistics systematically examines these kinds of suppositions. The commission's perspective that, in every day and every way, things are getting better, is probably not to be taken at face value.

I think there is a key object lesson for us here, as we contemplate the future prospects for Social Security reform. As the commission's good work demonstrates, there is a large, potential perception gap between the work of individuals who are

familiar with these issues' abstruse aspects and the way the issues are likely to be perceived by the public.

A recent preliminary analysis of the Boskin Commission Report that appeared in the *Washington Post* pointed out that telling Social Security beneficiaries that benefits for an average couple would be cut next year by \$200 or so as a consequence of the overstatement of the CPI will not be easy. Merely saying that it's quite all right, because Professor Boskin says so, is probably not going to fly with the general public.

One cannot spend as much time going to Social Security privatization conferences as I do and not conclude that this perception gap is huge and is likely to become even larger before it begins to close in the years ahead. For example, those of us who lived through health care reform went to many a conference where we discussed issues such as the impact of regional health care alliances and risk adjustment among plans and listened to wise people model the potential risk adjustment mechanisms that could be undertaken to even out the differences among plans. Nobody sat down and modeled for us the impact of "Harry and Louise" commercials, which, in the final analysis, proved to be much more instrumental in derailing health care reform than anybody's lingering concerns about how we would do risk adjustment among the plans.

Let me introduce what I think are some of the key reality gaps and perception gaps that I perceive, particularly in my work as a reporter covering these issues and also as an observer of the way these things have played out, as in the case of health care reform, over time.

■ Social Security Participants as Investors

With respect to partial privatization of the Social

Security system, the first issue is the education of tomorrow's investors who are going to make these wise investment decisions that may confront them in the future. Based on the tenor of much of the reader mail I receive—particularly when I write a column on Social Security—I have my doubts that a large segment of the population would be able to handle the investment choices involved. I am further buttressed in this view by statistics showing that 70 percent of Americans now get their primary news from television.

I don't expect Oprah, let alone, perhaps, even the CBS Evening News, to go into graphic detail when it comes time to explain annual investment choices that individuals may need to make or not make in order to maximize their investment returns.

Larry Summers, the Deputy Treasury Secretary, is fond of tweaking the financial press for running volumes of articles on how to pick a mutual fund with the best return without ever noting that, in fact, almost no one beats the market over time. If you were really smart and wanted to save yourself a lot of headache, you could probably just put your money in a stock market index fund and not worry about the emerging markets funds' return relative to some other funds' return, et cetera.

My experience suggests that many individuals are not going to be any match for the ingenious marketing that Wall Street and other investment houses are capable of, and I frankly have great doubts about the ability of many of the people whom I know to be among my readers to choose among investments and not get corralled into decisions that could be a large error for them over time.

A lot of people blithely point to statistics about how smart people are becoming as they invest in 401(k) plans. Again, I think there is a big reality gap that we have yet to fully contemplate.

■ Annuities Markets

Another perception gap or reality gap came up recently at a Council on Foreign Relations conference on privatization of Social Security and other pension funds around the world. There was discussion about how the linchpin of a partial privatization effort would be the availability of

some kind of well-developed annuities market so that people could cash out their personal security accounts at age of 65, or whatever, convert them to an annuity, and then have that money flow to them over time. Can we be confident that an appropriate annuities market would, in fact, materialize?

Those familiar with this issue know that there is a much debate among economists about whether this is possible. There are certain asymmetries of information between individuals and sellers in the current annuities market, and it is not clear that the pricing of annuities will operate in favor of the buyer.

When this issue was brought up at the Council on Foreign Relations conference, the financial market participants present simply stated, "Well, build it and it will come." That is, if you partially privatize, a flourishing annuities market will develop, and we can conquer all market opportunities. We have demonstrated our ability to do that. And everything will work out fine.

This may happen. However, important issues are involved in selling people a plan that is predicated on having reliable returns over the course of the investment period and also having a reliable way of securing the investment that has accrued up to the date of retirement. Merely hearing from financial market participants that these issues will take care of themselves does not increase my level of confidence that this is a salable plan.

■ Raising Taxes

With regard to selling these reform proposals to the public, there is yet another perception gap and a reality gap. It pertains to the partial privatization proposal put forward in the Advisory Council report. If, in fact, we deem the long-term shortfall of Social Security to be roughly 2.17 percent of payroll—or 4 percent if the life expectancy statistics are really as bad as we hear—then the personal savings account (PSA) plan requires at least a one-and-a-half percent payroll tax hike to retire the so-called liberty bonds that will be used to finance the transition. Is a 1.5 percent payroll tax hike to retire Liberty bonds inherently more salable than a 2.17 percent straight payroll tax increase?

This does not sound inherently more salable to me. If members of generation X are going to have to pay twice for our retirement and their own, do

they particularly care *how* they pay twice for it? It is not clear to me that one particular proposal is going to be more salable than another.

■ The Retirement Age

I would like to make two further points on the reality and perception gaps. The whole question of extending the retirement age is one that those of us in the press and in policy circles discuss in ways that simply do not take into account how this is likely to play out in people's lives.

Again, at the recent Council on Foreign Relations conference, there was a unanimous sentiment that the normal retirement age has to be raised. Why not age 70? After this conference was over, I wanted to take a survey asking how many people in that room actually will be compelled, for financial reasons, even to work beyond age 60. Given the tier of people who tend to go to meetings of this type, I would venture to say that nobody would have fallen into that category.

In contrast, to take an example close to home, my son's babysitter, now age 65, whose Social Security benefit is \$500 a month, will probably not only have to take care of my son until he is in college but presumably also care for my grandchildren in order to supplement her Social Security payment. Her expectations of retirement at *any* age are probably nonexistent.

Even if such people understand that they are going to have to work for a long time beyond what we would consider normal retirement age, telling them up front that their retirement age is automatically going to be raised to age 70 will be a very difficult political argument indeed.

Consider this together with James Smith's comments to the effect that the system is already going to be less progressive over time for those in the lower socio-economic strata.¹ It would suggest that the consequences of perceived social injustice for different classes of individuals are far greater than we currently perceive. In fact, this whole issue of class differences, socioeconomic differences, and

the way different categories of the population will perceive reform proposals has also not received sufficient attention and is probably impossible to factor into any kind of model.

■ Medicare and Social Security

The final perception gap I perceive is over this simple proposition: why is everyone paying so much attention to Social Security reform right now, when Medicare reform is obviously the bigger fish that needs to be fried? I have a feeling that if there were as many people—such as those on Wall Street—who had as great an investment in Medicare reform as they do in Social Security reform, I would spend a lot more of my time going to Medicare reform conferences these days than I do going to Social Security privatization conferences.

Gene Steuerle² and others have calculated that the Medicare long-term financial shortfall, if the current projections hold, is roughly three times as great as the Social Security long-term shortfall. That suggests to me that it is three times more important to start talking about Medicare reform than it is to talk about Social Security.

Even if we don't do that, we should be discussing the two programs in tandem. I cannot understand why we ever discuss them as separate propositions, since they are so clearly linked at so many levels. They are linked on the revenue side, with respect to financing by the payroll tax. They are linked, quite obviously on the expenditure side, with respect to not only federal expenditures but also to individual household expenditures.

It is a curiosity to me that we don't spend more time considering these programs together. I was heartened by Dallas Salisbury's comments that the effects of Medicare changes and corporate changes in retiree medical plans will conceivably be added into this modeling process in the future. Unless they are, I would suggest that we are not engaged in a particularly meaningful effort in evaluating Social Security reform on its own.

¹ See James Smith, "A Comment on Mortality Assumptions, Low Wealth, and the Need for More Saving," in this volume.

² See Gene Steuerle, "What Can We Learn from Modeling Social Security?" in this volume.

12

Investment Implications of Social Security Reform: More Questions than Answers

by Girard Miller

■ Introduction

The nonprofit organization that I head handles retirement plan administration issues for state and local governments. We are predominantly a defined contribution plan provider. Because of that, when we first looked at Social Security reform, we said, “This is great.” We are like everybody else in the financial services sector, trying to tap some new gold mine that will provide an unlimited number of assets to fuel the demand for plan administration and investment management.

As I became more deeply involved in Social Security reform, however, I found that it is much more complex than most of us would have thought a short time ago. I think we all need to address this issue at a deeper level. I am going to discuss several nontrivial questions and challenge you on a couple of issues as well.

When considering the fate of Social Security, I am reminded of the story of the English farmer who had the only horse in the county. One day the family came in yelling, “Something terrible has happened. The horse has run away. Woe to all of us.” They ran around town with scowls on their faces all day. The farmer, however said, “Don’t be alarmed. It’s too soon to tell.”

Sure enough, that evening, the horse came back with three wild stallions. Of course, the family was jubilant. “We’re now the wealthiest people in all of this side of England.” And the farmer again said, “Too soon to tell.” The next day, his son took out one of the wild stallions, ran it down to the end of the farm yard, and ran over a fence. The horse went head over heels, the kid broke his leg in three different places, ended up in the hospital in traction, and, of course, this was terrible. Those who were so happy in the morning now were morose because the harvest was due to come in, the son couldn’t help, and life was terrible. Again, the

farmer said, “It’s too soon to tell.” The next day, the army came into the land, conscripted every 18-year-old who was able to serve in the army, took them across to the other side of the world, where they all were killed—except for the farmer’s son, who was hospitalized that day.

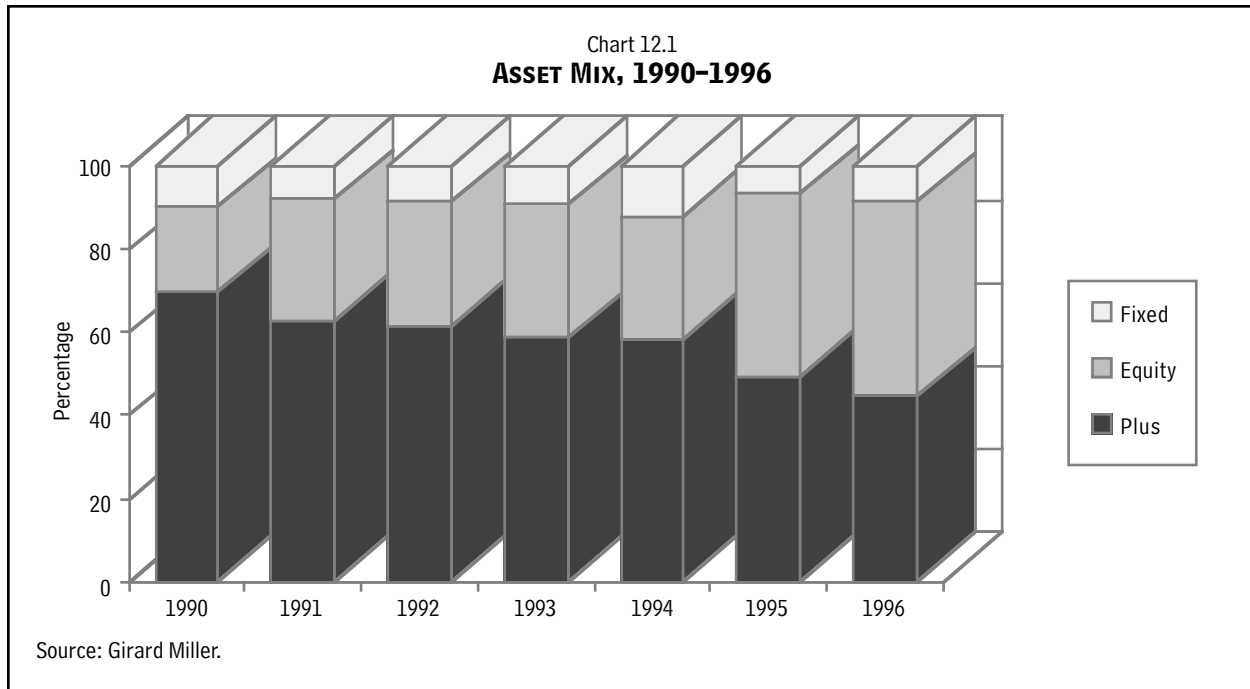
As we move into the world of Social Security reform, privatization and the rest, we should be mindful of the law of unintended consequences and of the fact the future is much more uncertain than the models suggest.

■ Workers as Investors

With that admonition about the perils of premature judgments, I’m going to start with one of the nontrivial issues. If 200 million or more people in the United States are permitted to invest their own retirement money, could they do it successfully? I think this is a fundamental question and one on which we will eventually need to spend a lot of time.

I can share with you information based on experience. Our organization, like many in our sector, had for some time been dominated by what we call stable-value investments—insurance contracts, and the like. Ours is a voluntary plan for most people; however, it represents the average city manager’s entire life savings. We have 260,000 people in this program; chart 12.1 shows the mix of a different series of voluntary retirement savings among state and local government workers.

In 1990, 70 percent or more of the money was in stable-value, or GIC-type, contracts. This number has changed dramatically. Some of the change reflects the great bull market of the 1990s, but a lot of it has to do with our concerted effort in employee education. We have developed the tools to help the average worker in state and local government better understand how to invest money



prudently. We have developed model portfolio packages. I think it can be concluded—after considering the numbers—that our program now looks much more like a traditional defined benefit pension plan in terms of the overall asset mix. Yet the plan even includes a large number of retirees.

So there is some hope that employees can, in fact, be trained, and I think the work that Dallas Salisbury and the others have been doing on the American Savings Education Council is indicative of that. As chart 12.2 shows, the allocation of recently contributed money now resembles the same mix that you would expect a private investment advisor to provide to wealthy individuals.

These are average numbers across a whole system. One thing I found interesting about the Employee Benefit Research Institute (EBRI) model is that it basically says, “100 percent is going to go into equities in the early stage of life, and 23 percent going into equities during retirement.” This actually is not that far from our particular group’s actual experience these days on the basis of new money in.

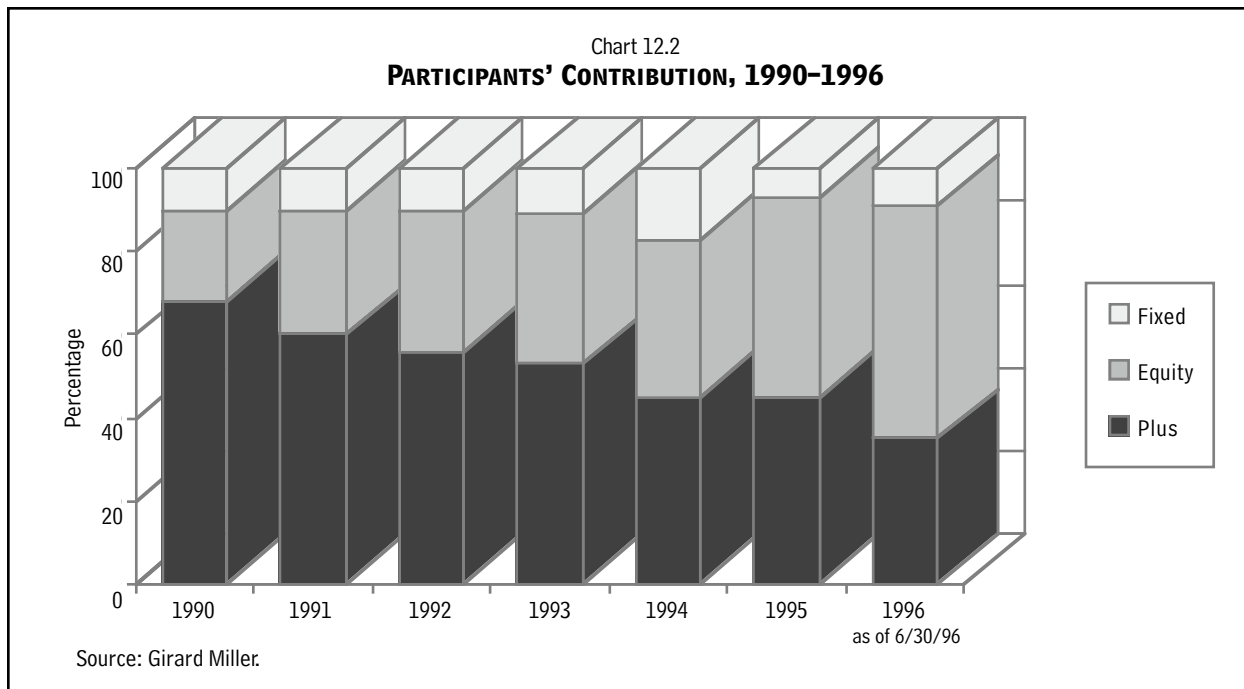
Next, I return to my original question: If 200 million people are turned loose to invest their own money, could they effectively manage it? Even if the answer is “Yes,” I think we then have to ask, “Will individual ownership of these assets necessarily be the best policy?” People will split on this

issue, based on economic philosophy, political philosophy, or whether or not they are involved in the financial management industry.

Economic science does not tell us much about this. There are major long-term implications of thrift that we need to think through as a country, such as whether or not there will be behavioral shifts. I don’t think the EBRI model is going to be able to predict the implications of telling massive numbers of American workers that the nest egg in their personal savings account will be their number one source of future retirement security. We need to think about this.

■ Costs

Another question to ask is, will not the Social Security safety net itself—whatever is left of it if privatization occurs—need to be extended to cover either losses on ill-advised investments or retiree cohort-specific market losses? I am referring to people who either bungle it in terms of their individual investment behavior, or the chance that those at the end of the baby boom cohort may experience a repetition of the recent Japanese stock market decline and its impact on retirees. Both of these scenarios could throw many people into a social safety net. We don’t have much in the dynamics of the EBRI model at this time that



addresses this fundamental question. I think it is one we need to understand better.

■ Administration

The next question goes to the administrators of Social Security. Will there be a national default investment product? That is an administrative issue about which we have heard very little intelligent discussion.

Concerning administration, at a practical level, what would be the expense ratio of the investment products, and what would be the plan administration fee, for offering all of this? We have good statistical data from the Society of Plan Administrators and Record Keepers on the cost of 401(k) plans, 401(a) plans, and 457 plans. We can give you these numbers, and they would probably drop by 50 percent in the five-year period that I predict it would take before we could implement privatization measures—even if Congress could be persuaded to start tomorrow.

Aside from that issue, we do not have numbers concerning what it would take in terms of relative costs to administer itinerant workers, part-time people, and others. My organization's plan probably has more small deposits and small accounts than any organization in the country. We know that, as a result, our average costs are higher

than those of the mainstream mutual fund and record-keeping providers. When we universalize to that segment of the population that lacks substantial wealth and assets, the average administrative costs for plan administration fundamentally will be higher than the costs the industry experiences now. Building in those expenses could raise a fundamental policy issue.

Even more importantly, we need to address the issue of the cost of the investment vehicle. Are we talking about three basis points for a Barclay's index fund, or are we talking about 90 basis points for Fidelity Magellan?

■ Regulation

From the standpoint of fundamental social policy, this leads to my next nontrivial question: "Who is going to regulate, and how will we regulate and control the investment products under a privatization scheme?" I think those at the National Taxpayers Union would say that they envision some kind of "guard rails" on the system. This implies that there would be a knowledgeable federal body that is able to determine what investment products are appropriate for a privatized scheme. And that, again, is not trivial.

■ Macroeconomic Considerations

Finally, I want to address a macroeconomic question: the issue of whether there truly will be a measurable effect on the returns and the risks of equity capital if we popularize the ownership of individual equity accounts through a fundamental change in Social Security. That is not a trivial question.

Such an initiative would change the supply of capital going into the equity markets. A practical macroeconomist could say that the essential long-term effect of that could be an eventual reduction of return on capital; that could have, I suspect, a significant influence on what measured return you expect from equity investments over the long term. This is a very interesting challenge, and more importantly, one that affects the stochastic and Monte Carlo models because it will change the risks.

Consider Japan, one of the superior societies in the world when it comes to savings, and reflect for a moment on the risk and return characteristics of the Japanese stock market in the last 15 years. That is, again, not a trivial question.

■ Conclusion

I have introduced more problems than answers, but they are fundamental ones. I want to congratulate EBRI for at least opening the dialogue. I conclude with one more challenging thought: Some people say that, without change, the Social Security system will be bankrupt by 2030. However, a large part of that deficit can be changed without anything related to the privatization of Social Security

accounts—with simple reform.

For example, in talking to people around the country, when I mention raising the eligible retirement age from 65 to 70, I see nothing but heads nodding in agreement. I don't think this concept would be as difficult to implement as some of the politicians and pollsters suggest. However, a higher retirement age of the Old Age, Survivors, and Disability Insurance (OASDI) program would have a profound impact on employers and also on those who administer retirement plans. It would change the behavior of individuals ages 62 to 70; for example, they might end up spending down money in other private accounts to fund early retirement.

Finally, we need to engage in a dialogue, similar to this one, with respect to Medicare—a system that will be bankrupt much earlier than Social Security. Some of us would say that, if the political priorities were straight, we would be addressing that issue first and Social Security second.

Certainly, there are many issues that relate to retiree health care. We should consider what potentially we should be doing with sec. 401(h) accounts in the current code. These vehicles could provide a means for employers and employees to save money to supplement, or complement, the existing Medicare system and to provide, for the first time, a market-based control on the demand for retiree health care. That is completely missing in this country today. So I hope you now can appreciate that we still have more questions than solutions. But, fortunately, we are on the right track in studying them now, well in advance of an actual political move. Just remember that it is too soon to tell.

13

Social Security: Myths and Realities

by Robert J. Myers

■ Introduction

I am in the rather unenviable position of being a status quo-er. It is always so much easier to have radical thoughts, to show that you are really thinking, than merely to say, “Keep on doing what you’re doing. It’s fine.” But to paraphrase a common expression, I don’t think Social Security is broke. Don’t throw it away. I think that it may need some change, and this would be prudent to do and would help restore public confidence. However, this should not be done radically or quickly but rather in a deferred and very gradual manner. None of us knows what the future will bring, and if action is taken in a deferred, gradual manner, it is much easier to change course later than if you act now in haste.

Robert Friedland¹ described excellently how, at the present time, many people are completely dependent on Social Security, and many are largely dependent on it, while very few are partially dependent on their children, and virtually none are wholly dependent on their children. In contrast, in the 1930s, those latter proportions were much higher. Social Security is doing an excellent job, so let us not throw it away.

Today, people talk a lot about how great investment accounts are, and I would not deny that they are. However, I don’t think that they take the place of Social Security, or even part of it. Also, the word “privatization” sounds good to people, like “motherhood” and “apple pie.” But if they really thought about what it means, they might not be so enthusiastic.

And I cannot believe that most people—aside from those who are well-educated and financially

astute—want to manage their money. What they are interested in is having at least a basic floor of economic protection, which is what Social Security offers, and then building on it as they choose. And maybe they don’t even choose to do it at all, but at least, then, they have that freedom.

Relying wholly on individual savings accounts, with individuals making their own investment decisions, sounds good to the financial elite. Choice is fine, but in a highly industrialized country like ours, people do not have complete choice. We do not have a choice whether or not to stop at a red traffic light. That choice has been made for us.

Furthermore, many people are saying, “Let’s change Social Security. We can do all sorts of things for the economy through Social Security.” I don’t think that is the case at all. I do not think Social Security’s purpose is to solve all national problems.

Some years ago, Social Security was criticized because it did not do enough to provide equal employment opportunities for women, or equal employment opportunities for minorities. That was not its role. I think that Social Security did develop more equal treatment, but these other elements are outside of Social Security. We should not expect too much of the program.

Today, people are saying, “We must change Social Security. We need more economic growth. We need more savings.” I won’t argue about that. That is not my field. Undoubtedly, we do. But I do not think that is Social Security’s responsibility.

■ Myths about the System

There are several myths about the original Social Security program of 1935 that still prevail and to some extent affect current thinking. One is that the original system was fully funded, similar to any good private pension plan. Or, at the opposite extreme, some say that it has always operated on a

¹ See David V. Bryce and Robert B. Friedland, “An Overview of the Origins of Social Security,” in this volume.

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pay-as-you go basis. Obviously, it cannot be both. In fact, Social Security was created as a partially funded system intended ultimately to provide investment income that would finance about 25 percent of the costs of the program, by building and maintaining a large fund.

The second myth about the original program was that it operated completely on an individual-equity basis. “Everybody would receive just what they paid for. This was a real insurance system, just like an insurance company would sell.” Again, this was not true. The original benefits were weighted heavily toward the lower paid and toward the people who would retire after contributing for only a few years. True, there was a provision stating that everyone was guaranteed to get back the employee taxes, plus a small allowance for interest, but that is not true individual equity. That is just a move toward individual equity, and the provision was eliminated in the 1939 Amendments.

Still another widespread fallacy is that the original act was intended to supplement individual efforts and supplement private pension plans. The fact is there weren’t a great many private pension plans in the early 1930s, nor were there a lot of savings, because they had been wiped out in the Great Depression. Instead, Social Security was put in as a basic guarantee, a basic floor of protection.

It has also been said that Social Security was established to reduce unemployment by encouraging people to retire and make jobs available for younger people. While it may have had a very minor effect on employment patterns, if that was the intention, it was a poor plan, because the monthly benefits were not scheduled to go into effect until seven years after it was enacted and then they amounted to only about 15 percent of earnings. How could that persuade people to retire voluntarily?

Several other myths are currently entering the debate about radically changing Social Security. One is that the program absolutely will go bankrupt in the year 2029, and that’s it. It is alleged to be an inflexible program that cannot be changed.

As has been frequently discussed, there are several actuarial cost estimates for the Social Security program. According to the low-cost estimate, which contains reasonable assumptions, the program is in great shape forever—not only for 75 years, but beyond that. I don’t think this is too

likely, but it is possible. Nonetheless, I think that we should soon take some actions that I will describe later. But it isn’t that we know that we must take action, but rather that it is desirable to do so.

Also frequently discussed is what I call the actuarial concept, “Do people get their money’s worth?” Or what about their rates of return? Many people believe these considerations to be very important.

These considerations are interesting, but they are not relevant. That is not the basic principle of the system, which is to provide a floor of economic protection or income maintenance. Whether people get their money’s worth or not is not material, any more than it is material as far as school taxes are concerned.

Another widely discussed matter is that the trust fund investments are worthless IOUs, because the money has been spent. However, the fact is that if the trust funds had not bought these bonds, somebody else would have had to buy them, and those bonds would have had the same validity and would likewise be part of the national debt. The fact that the bonds are not marketable is irrelevant, too, because much of the public debt held by private individuals is not marketable—e.g., the Series E bonds. They are redeemable at a scheduled value at any time, but they cannot be sold in the open market.

Furthermore, it has been said that the interest on the trust-fund investments will not be used for many years. This is not true. Just a few days ago, when some 43 million checks were mailed out or were credited to people’s bank accounts, securities were redeemed by the trust funds—despite the popular belief that securities will not be redeemed until 2019 and after, and this will then be a great problem. Securities are redeemed every month. Moreover, part of the benefits that go out each month come from interest—namely, the accrued interest on the securities that are redeemed. Looking at it from the standpoint of an economist, with money being fungible, you can’t say where the benefits came from—from money derived from payroll taxes or from interest on the invested assets. And, incidentally, in a sense, although it doesn’t mean anything very significant, the interest on the investments is now paid by check, not by a book entry or bookkeeping.

■ Modeling

I believe that, in connection with modeling, we are trying to be too scientific. I don't believe in stochastic modeling one bit. It is a great intellectual exercise, interesting to the technically minded. But, as a practical matter, I don't think whether people get their money's worth is relevant, and certainly not any more relevant than is the case in connection with school taxes. I certainly agree with Marilyn Moon's statement that, because the data are so variable, it is difficult to give much credence to the results that come out of this little black box.²

■ Privatization

As to privatization of the trust funds' assets, I think that this would be a bad idea. I think it desirable that the trust funds not be too large. I am an advocate of pay-as-you-go financing. Building up large trust fund assets is dangerous politically and economically, and the government should stay out of ownership of private industry.

Concerning the privatization of the benefit structure, as two of the three Advisory Council groups have recommended, it is interesting that its advocates approach it with various different agendas. Some people sincerely believe that privatization will provide better benefits for everybody—or, in other words, perpetual motion. Others view it from another angle: "Wouldn't this be good for my business? Look at all the additional investment business we will have." Still other people support privatization because, for years, they have been philosophically strictly opposed to Social Security, or to the government doing anything for anybody. In other words, they believe "Everybody should fend for themselves and, if they don't, that's their fault. Let them starve on the streets, but my money is mine, and if they don't have money, too bad."

One of the many problems with privatization is annuitization. Should it be voluntary or compulsory? Either way, there are problems. If it is done on a voluntary basis, it works out unfairly for women, because they have longer life expectancy. It also works out unfairly for one-worker families—

and there are still many of these families in the country—because they have to split the accumulation between two people; it does not go to a short-lived male.

Also, there is the problem of people without dependents who build up a large account and are not in good health, or perhaps die just before retirement age. What economic or social purpose has that large accumulation served?

Still another problem is what to do about the small accounts. Privatization works out well for steady workers with average or high earnings who make large contributions. Mutual funds and individual accounts cannot efficiently handle small dribbles of money coming in intermittently and then keeping track of the investment performance and reporting on it every three months. There would be very high administrative expenses.

People sometimes gloss over the difficulties with privatization involving the increased tax rates (which may not be popular), increased national debt, and increased budget deficits. I don't see how this approach can possibly get anywhere in a Congress that claims it is bound to try to balance the budget in seven years, not make it larger.

The proposals that I have seen do not give any indication that they have smoothly merged disability benefits and the young-survivor benefits with the retirement benefits. I think there could be sharp notches and glitches among people who draw down their accumulation at the wrong moment or die just before retirement age or just afterwards. On the other hand, the present Social Security program has, generally speaking, very smooth junctions.

■ Maintaining the System

I will end with my proposal. What I think ought to be done is to maintain the Social Security system as we have known it, as it has operated for 60 years, but make changes in it that are reasonable, affordable, and logical.

One change is to raise the normal retirement age. That reduces the benefit cost, but I don't consider it a "real" benefit reduction in view of the value of the lifetime benefits. If the age were raised slowly to 70, as it is now, starting in 2003, but getting to 70 by 2037, people age 70 in 2037 would probably live about as long as people retiring at age

² See Marilyn Moon, "Social Security Reform: Beyond the Models," in this volume.

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65 today. Thus, that is not a “real” benefit cut. It reduces benefit costs on a year-by-year basis, but not on a lifetime basis.

The other part of this proposal would be the traditional one of not only reducing benefit costs but also raising income. I would increase the tax rate, beginning in 2015, by 0.3 percent each on the employer and the employee, and then impose a similar increase in 2020, 2025, and 2030, a total increase of 1.2 percent on each. With any sort of real growth in this country, people’s real incomes will continue to rise in those years. Further, even if some increased portion of earnings is taken away for higher medical costs, I think that real incomes will still rise.

And even if real incomes do not rise, do Americans have to be so unaltruistic? Do they have to be so concerned with constantly rising incomes, and have five cars in every garage, and three television sets in every room? We have a very high standard of living in this country for most people. Something ought to be done with regard to those whose living standard is inadequate. But the majority ought to be satisfied with what they have, or at least with smaller increases than would occur if they did not consider the needs of others.

I also think that it might be desirable to establish mandatory individual accounts that

would be completely separate from Social Security, and see how it works. And again, leave out the very lowest paid, because it is not efficient to include them, and it would do little for them.

Finally, I would reallocate the Social Security tax rates beginning next year and cut the Social Security rate by 0.6 percent each on the employer and the employee, and put that money into the Medicare Hospital Insurance (HI) Trust Fund. By doing this, the Social Security trust-fund reserve would remain at a satisfactory contingency-reserve basis. This would give Medicare HI an extended lifetime during which a solution to its long-range financing problems could be worked out. I think that the eventual solution for the HI problem will involve higher costs, and people can bear it. At least, my proposal would remove the problem from the immediate front burner.

■ Conclusion

What I propose would solve several problems, and it would maintain what has been, and still is, a highly successful program. It would not put us in danger of a new, radical solution that might create a terrible mess and create all sorts of problems that we cannot imagine at the moment.

14

The Maintain Benefits Plan for Social Security

by Robert M. Ball

■ Introduction

Much to my surprise, I found my participation in the 1996 Social Security Advisory Council to be quite an educational experience. Having been associated with some five earlier councils as well as having worked for Social Security for 30 years, I had thought that my positions on Social Security were pretty well set. But out of the discussions in this council, I actually came to adopt one important proposal—one that was completely new for me. I would like to explain to you how I came to advocate investing some of the Social Security build-up directly in passively managed private equities indexed to the broad market.

Mainly, the reason for my advocacy is that I became convinced that we had to do something about the perception of younger people who believe they are not getting a good deal under Social Security. And at the same time, I was convinced that one way of attacking this problem—individual private investment taking the place of all or part of Social Security—was a bad idea.

I doubt that most young people believe they are not going to get any benefits from Social Security; but certainly a very large number of them have concluded that Social Security is not a good deal for their generation. The point is not whether I believe “money’s worth” and the “rate of return” should be major criteria for judging Social Security. The point is that if Social Security is to survive, those who are going to vote in the future need to understand and support it, and *they* believe that money’s worth—the ratio of benefits to contributions—is an important criterion in deciding whether or not the system is fair.

So I started to look at this issue more seriously than I had, particularly as groups within the council started to argue that the way to improve “money’s worth” for younger people would be to privatize, or partly privatize, Social Security—that

is, to take some of the money that goes into Social Security and give it back to workers to invest in personal accounts. The argument was that presumably individuals would invest some of this money in private equities and, on average, this would result in bigger returns than Social Security investments, which are limited to the returns payable on long-term government bonds.

■ The Problems With Individual Accounts

It is true that generally this procedure might well improve the return on contributions, but as I studied the proposals for individual accounts, I saw many other problems with them. One is that this approach greatly reduces benefits in the government part of the program (a 30 percent reduction in the average individual account (IA) plan and much more in the personal security account (PSA) plan). Thus, under these plans what you have left in the government part is much worse than the current plan in terms of money’s worth for the very people whose status you are trying to improve.

And you cannot expect those covered by Social Security to look always at the total program—what they get from their own individual accounts together with Social Security. They will look at the residual Social Security program separately. Over time, those average and above-average earners who turn out to be successful investors in their own individual accounts will see these accounts getting better and the residual Social Security program getting worse. Increasingly many may begin to argue: “Why can’t more of the contributions that are going into Social Security go into my individual account? Why not just drop Social Security?”

That is why I believe that these two-part plans with individual savings accounts have in them the seeds of dissolution for the whole Social

Security program. The redistribution of income that has made Social Security such a successful antipov-erty program and such a successful program for low-income people could disappear. Those who are doing better than average in their individual accounts may not be much concerned with those who are doing worse than average. But if they lose interest in the traditional program, by default Social Security could become a low-income program—and end up with the resulting weak political support common to all low-income programs.

And there are many other problems with partial privatization plans. For one, I doubt whether the savings would last until retirement. The idea behind individual accounts is to emphasize that they *belong* to the individual. As people face financial crises during their working careers, Congress probably would allow them access to the build-up in their accounts, even though in theory it is all supposed to be held for retirement. But consider an individual who is still unemployed after having exhausted unemployment insurance; is the Congress going to say that person has to seek relief regardless of the size of a personally held account? What about major medical expenses? Or the desire to have a starter house? Or education for one's children? If it is the individual's own money, the Congress will be under great pressure to make it available.

Another problem is that both of these privatization plans in the Advisory Council Report substantially increase the compulsory payments (taxes) that people have to make. The IA plan increases deductions from workers' earnings by 1.6 percentage points, which is then put into the individual account. The goal is that the 30 percent average reductions in the residual Social Security benefits on average will be compensated with returns from individual investment. That may work—on average. But what about all those whose returns will be less than average; or what about those who may even lose all or part of the principal? The basic tier of our traditional three-tier plan for retirement income should continue to be Social Security, a defined benefit plan on which people can rely, without dependence on returns from individual investment. Then supplementary savings and even supplementary pension plans, the second and third tiers, can be somewhat more at risk without endangering minimal protection.

The larger of the partial privatization plans in the Advisory Council Report, the PSA plan, increases the payroll tax by 1.52 percent and borrows from the federal government (\$2 trillion at the peak), greatly increasing the deficit and the U.S. debt for the next 72 years. This plan would eliminate the traditional wage-related Social Security program, substituting flat benefits even though it still would be supported by a wage tax. The higher paid would pay many times as much as lower-paid workers but still get the same benefit.

These proposals do not seem attractive. Above all, they weaken the reliability of the nation's basic retirement system by shifting it in part from a defined benefit to a defined contribution system. This approach requires workers to set aside additional income for the sole purpose of retirement, regardless of what families may require for protection against health care costs or to meet other needs that are more immediate than retirement. Both plans have particularly harsh benefit cuts for the totally disabled, and both increase the difficulty of adequately financing Medicare because they take more from wages for the single purpose of increasing retirement savings.

These plans force the first generation or two of workers to pay twice—once to build up their own individual accounts and once to continue paying for benefits for others under the current pay-as-you-go system. The PSA plan does not require annuitization, and thus it introduces a new uncertainty as to whether the accumulated funds will last an individual's lifetime. Both plans undoubtedly exaggerate their contribution to increasing national savings because they do not take into account any reductions that individuals would make in their current voluntary savings if they are compelled to save additional amounts through the government program.

■ Administrative Problems

The larger privatization plan, the PSA plan, also presents quite overwhelming communications and administrative problems. It would be very difficult to make clear, such as in an informational pamphlet, the kind of protection people would have during the transition period. It is extremely complicated. It also is difficult to see just how the government would ensure that 5 percent of wages

actually was deducted from workers' earnings each payday and sent to a designated broker, bank, or other financial institution and then kept there, or, if moved to another financial institution, properly reported again to the government.

This might work for those who now have 401(k) plans, but enforcing the provisions of such a law in the case of hundreds of thousands of small employers seems very difficult—much more difficult than the reporting requirements under Social Security. In summary, the six of us found a lot of problems in the individual account plans and believed that if the rate of benefits and contributions were to be improved for younger workers, we would have to find another way.

■ Bringing the Current System Into Balance

It really isn't too hard to balance Social Security over the next 75 years. There are quite traditional ways of doing so, and the six of us who generally support the present system have made several common-sense proposals that reduce the 2.17 percent of payroll down to 0.80 percent of payroll, without major increases in contributions or major reductions in benefits. They are listed in the Advisory Council report, and I repeat that table here:

Table 14.1
REDUCING SOCIAL SECURITY'S LONG-TERM DEFICIT

Impact of Specified Changes in Coverage, Calculation of Benefits, Taxation of Benefits, and Adjustment for Correction of the Consumer Price Index
(Shown as a Percentage of Payroll)

Change	Impact on Deficit
Long-Term (75-year) Deficit	2.17
Increase taxation of benefits	-0.31
Redirect taxes on benefits from HI to OASDI (effective 2010-2020)	-0.31
Extend coverage to new hires in excluded state and local positions	-0.22
Adjust for Correction of CPI	-0.31
Increase length of computation period from 35 to 38 years or increase payroll tax 0.3 percent	-0.28
Adjust for interaction among proposals*	+0.06
Total	+1.37
Remaining deficit	-0.80

*The impact of a proposed change may increase or decrease somewhat in interaction with others. For example, taxation of Social Security benefits will produce less income if benefits are reduced, and increasing the wage-averaging period reduces benefits an average of 3 percent.

You also can go the rest of the way and eliminate the remaining 0.80 percent of payroll deficit with changes that are well within the tradition of Social Security's past changes. You get another 0.50 percent reduction in the deficit if you are willing to raise the retirement age above age 67 as scheduled in present law, and, as a majority of the council recommends (although I do not), raise it automatically in the future in accord with increases in the length of life. Then, if benefits were cut 6 percent (instead of the 3 percent in our plan), these two changes together would bring the 75-year estimates into balance.

Another possibility is that over the next few years the Bureau of Labor Statistics may make further corrections in the Consumer Price Index, which governs increases in the cost of living. So it could be that the program will be brought entirely into balance in these ways and without major benefit cuts, increases in taxes, or departures from past practices.

■ Investing Reserves

These changes, however, would not improve money's worth for young workers and would cut benefits more than we believe desirable. So what should we do? We recommend a shift from pay-as-you-go financing to partial reserve financing and consideration of ways to improve the return on such a reserve. In particular, we propose a careful and sympathetic study of another way of eliminating the 0.80 percent of payroll deficit: Invest a part—up to 40 percent—of the accumulating trust funds directly in passively managed private equities, indexed to the broad market.

The easiest way to get a sense of how much improvement in money's worth results from investing 40 percent in stocks is to study chart 14.1. Money's worth (that is, the present value of lifetime protection furnished compared with the present value of employer and employee payments) differs substantially for any specific investment scenario by reason of the composition of the beneficiary group and the workers' ages at the point of time considered. To get a sense of money's worth for the combined Social Security population under various investment proposals, the Advisory Council created the concept of a "composite worker" and measured money's worth for this worker by age.

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The composite worker is a theoretical construct representing single workers, married couples with one spouse working, and married couples with both spouses working in proportion to their presence in the beneficiary population. They are assumed to have lifetime earnings in the proper proportion for each demographic group. The Social Security taxes and other payments are the ones appropriate for the birth dates shown in the horizontal scale. The present value of the Social Security protection furnished takes into account the probabilities assumed in the 1995 Social Security Board of Trustees' report for retirement, disability, and survivors benefits, including eligibility for the benefit rate and the length of payment. The present value of the payments is computed, assuming an ultimate 2.3 percent real valuation interest rate, or the rate assumed for long-term government bonds, and a 7 percent real valuation rate for investments in the stock market.

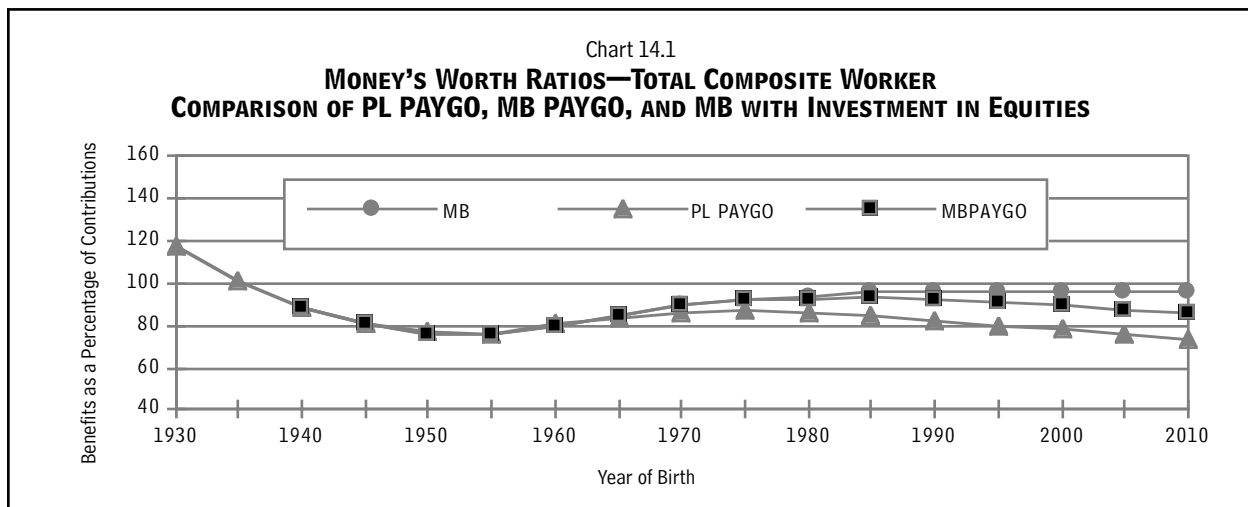
The horizontal scale on the chart measures the extent to which money's worth for the particular plan reaches 100 percent of the money's worth provided by a *fully advance-funded system* earning the long-term bond rate of 2.3 percent. Because what is being measured falls far short of a fully advance-funded plan, it is not surprising that the money's worth results fall short of 100 percent on the scale—even though some investments are assumed to earn more than 2.3 percent (7 percent real, for example, for investments in the stock market).

To understand the difference between the maintain benefits (MB) plan with investment in

stock and the present pay-as-you-go plan or the MB plan turned into a pay-as-you-go system after using up the MB proposals short of stock investment, look at the three lines on the chart. The MB plan with investments of 40 percent in stocks reaches 96 percent in the horizontal measure and stays steady (representing a 4.2 percent return on combined investments), as compared with a constant deterioration in money's worth from one cohort to another for each cohort born after 1975 for both pay-as-you-go plans.

The idea of investing part of Social Security funds in stocks is a new enough idea for Social Security that we are not urging its immediate enactment. In a program like this, which affects just about everyone in the country, we believe that major changes should come about only after the development of a considerable consensus. So we favor moving promptly on those common-sense proposals that are relatively easy to do and that also will bring the Social Security trust fund much closer to balance. At the same time, we hope the Administration and the Congress will be carefully examining and researching the idea of directly investing in the stock market, as is now done by almost all other pension systems, i.e., practically all state and local systems and private pensions and many federal employee plans, such as the defined benefit plans of the Federal Reserve Board and the Tennessee Valley Authority.

We have described a specific plan as a basis for evaluation of this idea, although, of course, the details may well come out differently. Short of a government contribution, investment in stocks is



the only way we envision that can bring the system into long-range balance and at the same time improve the benefit/contribution ratio for younger workers and future generations. If instead benefits are cut further, or taxes increased more, the result will be an improvement in the balance of the plan over 75 years; but, at the same time, there would be a worsening—not an improvement—in the benefit/contribution ratios for young workers.

The plan that we have outlined, which limits the amount invested in stocks to ultimately about 40 percent of the Social Security build-up, never would put the government in the position of owning more than about 2.5 percent to 5 percent of the total value of all stocks. Our proposal would follow the general approach of the Federal Employees Thrift Plan. That is, the President would appoint an expert financial board, with members confirmed by the Senate. This board would have only three functions:

- It would select the index that would govern the investments in stocks and which would make the investments representative of the broad market.
- It would select, by bid, the portfolio managers who would keep the stock portfolio in tune with the index.
- It would report to the Congress and the country on how the plan was working and also make changes in portfolio managers and indexes as seemed appropriate.

But these three functions would be the limit of the board's responsibility. Nobody would be picking stocks. There is no loss of return in that procedure; it is very unusual for active management over any long period of time to beat market rates of return. We would not propose that Social Security try to do so.

It also is important to insulate Social Security's holding of stocks from any influence on company policy. So Social Security would not be allowed to vote stock proxies, just as is the case

with the Board of the Federal Employees Thrift Plan. One could eliminate the voting rights outright or have them exercised, not by the owners, but by the portfolio managers (as is done by the thrift plan). Another possibility is to have the voting rights of the stocks held by Social Security cast in the same proportion as the votes cast by other owners.

■ Conclusion

I want to make absolutely clear that the six of us who support the maintain benefits proposal do not consider the three proposals that came out of the Advisory Council to be the three best possible proposals. If our plan were not adopted, we would not select one of the other two as the second-, the third-, or even the fourth-best plan. We are completely opposed to the idea of partly privatizing Social Security by reducing Social Security benefits and putting either new money or part of the Social Security contributions into individual accounts. We think there is an overwhelming case against such plans and oppose them in any guise.

There is no need to make such radical changes in the Social Security system. Its financing under current law is assured until about 2030; and at that time, current law still would support 75 percent of the cost of benefits. Even in 75 years, current law would support more than 70 percent of the cost of the benefits. The problem is how to assure 100 percent payment from 2030 on. Most of the cost of benefits after that date already is covered. The rest of the job can be done, and doing it is really not that hard.

The situation with Social Security is similar to that of homeowners living in a sound house. They like it very much; they only need to have its mortgage refinanced. There is no need to tear the house down, remodel it, or trade it for a different house. The need is only to improve its long-range financing.

15

The Case for the Individual Accounts Option

by Lawrence H. Thompson¹

■ Introduction

I have agreed to outline the case for the “independent accounts” approach, the particular option associated with the Chairman of the Social Security Advisory Council, Ned Gramlich. I am pleased to do so because I believe it illustrates a general approach that has much to commend it. It is an approach that attempts to strike a reasonable compromise among several legitimate, but not necessarily compatible, objectives of Social Security reform.

Each of the three options advanced in the Advisory Council report produces a retirement income package that on average provides benefits equal to (or slightly higher than) those scheduled under present law for steady, long-service workers retiring between now and 2045 or so. Each is adequately financed under reasonable assumptions about future demographic and economic trends—not just for the traditional 75-year projection period but for the years thereafter. Each raises the value of the Social Security protection offered to the Social Security contributions paid for today’s younger workers.

■ Different Approaches

The proposals achieve these results, however, by employing different approaches with different strengths and weaknesses:

- The “maintain benefits” approach comes the closest of the three to preserving both the approximate scope and structure of currently scheduled benefits. The financing strategy differs from the other two strategies in that

some income tax revenues now going to the Medicare are shifted to the cash benefit program, and up to 40 percent of the assets of the central trust fund are invested in equities. Contributions are increased by 1.6 percent in 2045.

- The “individual accounts” approach reduces the current benefit package to a level that can be financed with the current 12.4 percent tax rate, a reduction that averages about 30 percent when fully phased in. It adds a new individual account financed by a new 1.6 percent employee contribution. The balances in the individual accounts are converted into indexed annuities and added to Social Security checks at the time the worker retires. Under the assumptions used to project the impact of each option, the individual accounts would, on average, offset the reductions made in the defined benefit portion of the Social Security package, producing total benefits similar in size to those produced in the maintain benefits approach.
- The “personal security account” approach replaces the current old-age benefit with a flat benefit paid at an amount similar to today’s Supplemental Security Income (SSI) benefit. About one-half of the contributions used to finance today’s old-age benefits, 5.0 percentage points, are diverted to individual accounts. The individual accounts are managed by a private firm chosen by the individual worker, subject only to minimal regulation about how they are invested. Workers are free to withdraw accumulated assets however they like after qualifying for retirement. The revenues lost by diverting 5.0 percentage points to individual accounts are replaced by massive new government borrowing; the new debt is retired over a period of 72 years with the proceeds of a 1.5 percent payroll tax.

¹ Senior Fellow, *The Urban Institute*. The views expressed here are those of the author and not necessarily the *Urban Institute*.

I see two important advantages in the individual accounts approach:

- The approach responds to the desire of many younger workers to incorporate a element of individual accounts into the Social Security package; however, it does so while preserving the advantages of having a substantial defined benefit component to the retirement income benefit package and the administrative efficiencies inherent in a coordinated system for collecting and managing funds.
- The approach encourages increased personal saving that will help increase the size of the economy from which future retirement benefits will have to be paid. It does so, however, without sacrificing the effectiveness of our Social Security program as a mechanism for assuring adequate retirement incomes or relying on a somewhat problematical mechanism for financing the transition to greater advance funding.

■ Providing for Individual Accounts

As its name implies, the “individual accounts” approach provides each worker with an individual account as an integral portion of the Social Security package. The account is financed through a mandatory contribution. To the worker, the system looks very much like many of today’s 401(k) plans. The accounts are managed centrally, but workers are offered several options as to how they wish to have their accounts invested. These might include several broad-based stock index funds, several bond funds, and a couple of money market funds. Workers could participate in their own retirement planning by selecting the investment package they prefer. When they reach retirement age, the amount in their individual account would be converted into a price-indexed, life annuity and paid to them as an integral part of their Social Security benefit.

One advantage of this approach is that it introduces individual choice in investment vehicles while helping to insulate workers from some of the risks inherent in retirement planning. The insulation comes both through the preservation of a major role for a defined benefit component of Social

Security and through the requirement that individual account balances be converted into indexed annuities.

■ Risks Associated With Retirement Planning

In principle, workers could save for their own retirement simply by setting aside a fixed percentage of their earnings each pay period without any need for a government program. Far-sighted workers entering the labor force who decided to plan ahead for retirement quickly would discover, however, that their planning needed to deal with several risks inherent in retirement planning.

Cohort Life Expectancy

First, to know how much to set aside each pay period, workers will need to know how long their cohort can expect, on average, to live after reaching whatever retirement age they select. This requires projecting mortality trends some 40 to 60 years into the future. Such projections are currently a matter of heated debate among demographers and one of the areas of greatest uncertainty in Social Security’s long-range projections. If mortality improves more than workers expect, they will find that they have not saved enough when they reach retirement age. If mortality does not improve as much as they expect, they will have saved too much.

Future Economic Growth and Investment Returns

Faster economic growth implies a more rapid increase in living standards over the course of the workers’ lives, leading to the need for additional resources if preretirement incomes are to be maintained. The difficulties in projecting investment returns is one of the key topics that the Employment Benefit Research Institute (EBRI) hopes to research over the next few years. The challenge is to do the best job possible in understanding the implications of what inherently is uncertain.

Relative Earnings Level

A third source of uncertainty is the earnings level of each worker relative to the entire cohort. In

general, those with lower earnings will find saving for retirement more difficult, but they also will need to have a higher benefit (relative to previous earnings) to preserve their preretirement living standards. In a world of corporate downsizing, workers who may have thought that they could count on high incomes and generous employer benefit packages may find their expectations upset midway through their working careers.

Individual Life Expectancy

Once the cohort reaches retirement age, each member must deal with the uncertainty over his or her own life span relative to that of the other members of the cohort. Those who die relatively soon after reaching retirement age probably will have saved more than they needed to and will leave estates. Those who live beyond the average life expectancy of their cohort run the risk of outliving their assets.

Inflation

Finally, workers entering retirement face the uncertainties associated with future changes in price levels. Inflation averaging 7 percent annually will reduce the purchasing power of a given monthly benefit by one-half in 10 years and by three-quarters in 20 years.

■ How Risks Are Distributed in Different Retirement Income Vehicles

Different retirement income institutions handle these risks in different ways. The old-age benefit portion of the current Social Security program is a defined benefit plan designed so that society as a whole shares each of these risks with the individual worker. It is precisely this feature of Social Security that makes it social insurance.

Employment-based defined benefit pension plans also help workers deal with several of these risks. In particular, the plan sponsor assumes the risks associated with changes in cohort life expectancy, uncertain investment returns and rates of economic growth, and (in most cases) the risk that any given individual will live beyond his or her cohort's life expectancy. Employer-based plans do not deal as well with uncertainties about the

individual's earnings relative to the cohort average and tend not to deal with inflation after retirement.

In most defined contribution plans, workers bear all five of these risks by themselves. The worker can reduce the fourth risk, that of outliving one's assets, through the purchase of an annuity, but the market for individual annuities is very imperfect. Workers easily may lose a quarter of the value of their accumulated assets in the process of converting them into annuities if done on an individual basis. In principle, in the future the worker also will be able to deal with the fifth risk, post-retirement inflation, by purchasing a government bond indexed to the consumer price index. In effect, the government will assume that risk for any bond purchaser, just as it now assumes the risk for Social Security beneficiaries.

■ Preserving a Mixed System

The current retirement income system is a mixed system in which the Social Security program is designed to provide about one-half (more for lower earners and less for higher earners) of the income needed to preserve one's preretirement living standards. The balance must be supplied by employment-based programs or through personal savings.

Unfortunately, the trend among employment-based programs is toward increased reliance on defined contribution systems and reduced reliance on defined benefit systems. Thus, the employer-provided portion of the system already is moving in the direction of forcing individual workers to assume a greater portion of the risks inherent in planning for retirement. Although there is no magic formula for dividing these risks, it would seem unwise to convert to a system that transfers virtually all of the risks to the individual worker.

The individual accounts option allows risk to continue to be shared between the worker and society. It preserves a substantial role for the defined benefit portion of Social Security, and it converts the balances accumulated in workers' accounts into price-indexed, life annuities.

■ Administrative Efficiency

The individual accounts approach piggy-backs on the same mechanisms currently employed to collect Social Security contributions. This is a very effi

cient mechanism for transferring and recording worker contributions. It probably is the only mechanism that makes sense for a mass program like Social Security.

Each year, the Social Security Administration posts some 190 million different wage items. Each item represents the annual earnings of one worker derived from one employer. The median wage item is \$15,000. A worker who earns \$15,000 over the course of a year receives, on average, \$575 every two weeks. A worker required to contribute 5 percent of his or her earnings to a mandatory savings account (the proposal underlying the PSA approach), would be making a contribution of just under \$30 out of each pay check.

Now, imagine a world in which every worker gets to select a mutual fund company to manage his or her assets and in which each worker's employer is responsible for withholding and remitting the regular contributions required of this worker. The employer of a modest-sized work force could easily find that every worker had selected a different mutual fund company, leaving the employer to send each such company a check in the amount of \$30 (more or less) every two weeks.

In addition to the employers' costs, the individual mutual funds will incur operating and management costs, which the Advisory Council assumed would amount to about 1 percent of the assets being managed. While indexed mutual funds clearly can manage moderately large accounts at these or lower cost levels, it is not clear how cheaply they can manage the much larger number of much smaller accounts this plan entails. Nor can more actively managed or specialty funds operate at these expense levels.

Surely, there must be a more efficient way to run a series of individual accounts than to have 190 million checks with an average face value of \$30 running through the banking system every two weeks and to have hundreds of different firms duplicating administrative structures to manage millions of modest-sized accounts. There is: the individual accounts approach, under which the payment system is centralized so that each employer needs write only one check—to cover income tax withholding, regular Social Security contributions, and the mandatory individual supplemental contribution—and under which fund management is streamlined.

As compared to the other approach to indi-

vidual accounts, workers also will benefit from:

- lower administrative costs associated with managing their money,
- lower administrative costs associated with making regular benefit payments, and
- lower transactions costs associated with converting account balances into annuities.

■ Increased Personal Savings

Money accumulated in the individual accounts will be invested in private-sector securities. It will represent additional funds available to finance domestic investment. To some degree, this should facilitate an increased pace of domestic investment, leading to somewhat faster economic growth. Additionally, to some degree, it may displace the funds that now are being imported from abroad to finance U.S. domestic investment. In either case, our national income would be higher in future years.

All three options contained in the Advisory Council report call for increased investment in private-sector securities as a key element in increasing the benefits associated with a given level of worker contributions. Under the individual accounts and personal security accounts options, such investment also is explicitly designed to increase national saving. Of the two, however, I believe that the individual accounts is the far more reliable approach.

The individual accounts approach follows a very straightforward strategy: Workers are asked to contribute an additional 1.6 percent of their taxable earnings to their accounts. This is an addition to the current Social Security tax. It forces a reduction in consumption, which is the only way in which savings can be increased.

The personal security account approach imposes an additional payroll tax of essentially the same size. If the plan actually were to be executed as designed, it would have a very similar impact on national saving because it essentially would have the same impact on aggregate consumption. However, the plan relies on a much more complex financing arrangement that easily could turn out to be far less effective. The additional payroll tax does not flow directly into additional saving; it is used to retire a huge special issue of government debt that

is issued, in turn, to finance the transition between the current system and the system envisioned by the proponents of the personal security option. The plan rests on the somewhat risky assumption that future Congresses will consistently decide to continue levying a payroll tax on working Americans for the sole purpose of retiring debt, a tax that would seem to be an obvious target in times of economic distress or political competition.

■ Preserving Medicare Financing

One troubling aspect of the maintain benefits plan is the diversion to the retirement and survivors program of some of the resources currently going into Medicare. In effect, such diversion amounts to a hidden tax increase because it creates the need to find substitute resources for Medicare. The individual accounts plan avoids such financing devices.

■ Conclusion

Over the next half-century, demographic shifts will force an increase in the cost of supporting the aged population. One implication is that currently scheduled Social Security benefits cannot be financed with currently scheduled revenues.

The members of the Social Security Advisory Council concluded that the system ought to preserve a set of benefits which, in the aggregate, were similar in scope to those scheduled currently. Each also came to the conclusion that one way to finance these benefits was through some form of equity

investment in the Social Security program.

A benefit package fairly close to the current package can be financed directly if some of the money now scheduled to go to Medicare is diverted to the pension program and up to 40 percent of the reserves of the program are invested in equities. Such a package does the best job of preserving the current defined benefit protection for future retirees, but it makes no provision for individualized accounts.

A radically different approach involves cutting by some 60 percent the current defined benefit component of the program and shifting the majority of the responsibility for future Social Security retirement benefits to relatively unregulated individual accounts. This approach does introduce individual accounts, but it sharply reduces the degree of worker security provided by defined benefits paid as real annuities.

The individual accounts approach represents a reasonable compromise between these two approaches. It does require an immediate increase in the total amount being contributed for Social Security, which is precisely why it has the potential to increase national saving. It also allows for a degree of self direction through a system of individual accounts; but it preserves 70 percent of the current defined benefit package and forces the additional resources accumulated in the individual accounts also to be annuitized. This approach strikes a reasonable balance between potential improvements in the macro economy and maintenance of adequate worker benefits.

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Comments on the National Thrift Plan

by Neil Howe

■ Introduction

The assertion was made several times that the fact that individuals can't beat the broad market is an argument against personal accounts. And obviously, those of us who are proponents of this approach say just the opposite. That's what makes personal accounts possible. It means that people can invest in indexes, and they can invest in broad market instruments, and do just as well over the long term as those who pay commissions to a lot of fancy brokers.

What people really want assured under this system is that, when they invest in a personal account, not that they can get some broker to make clever choices but that, first, their money will be economically saved. Most people think that is true about Social Security, and when you inform them that it is not, there is genuine surprise. They are shocked—particularly older people, not so much the young. They know basically how the fiscal accounting works.

The second consideration is that it is money over which they are assured ownership, and this is a basic political and constitutional point. I think that, particularly after I have talked to a lot of young people, what they are really concerned with is the ability of the government to keep promises, perhaps even more than the ability of the Dow Jones to live up to its expectations.

■ The National Thrift Plan

Let me start by explaining how the National Thrift Plan came about. Setting out, we had two overall objectives, the combination of which put us somewhere in the middle of the Social Security reform debate. Or at least it put us somewhere in the middle among those who were looking at reform.

On the one hand, we wanted to design a visionary plan that would truly go after the root

problems of the current Social Security system: its massive unfunded liabilities; its enormous projected fiscal deficits; its disincentives to work effort and private-sector savings; its evaporating level of public trust, particularly among the young; and, most seriously, a low and declining rate of return on Social Security contributions. This definitely put us on the visionary side of those who simply want a few reforms, as little as possible, to keep the system we have.

Specifically, we wanted a fully funded plan that would allow workers to invest their contributions into the real economy, and a plan that, once mature, could never run a deficit. We wanted the assets of this plan to be personally owned and managed as common law property of each contributing worker. Unlike Social Security, these retirement assets could never be changed or reduced by Congress, nor could government ever use them to paper over its own deficits, its own red ink.

We wanted this plan to afford a more generous protection for elder Americans in poverty than our current system. We also wanted it, like our current system, to subsidize the retirement security of low-income workers, but to do so on the savings side before retirement, not on the benefits side after retirement. That is the whole concept of the match that we provide for low-income individuals, basically using the Social Security Administration definition of low-income workers, which is 45 percent of the average wage.

We wanted the plan to offer all new retirees higher total benefits, and eventually to offer everyone a much better retirement deal on their contributions than the current system provides. Most importantly, we wanted the plan to boost productivity and real wages throughout the economy by adding hugely to the national savings. I am sure if you look at our plan you will see that this effect on national savings is quite profound.

We wanted a visionary plan. Yet, on the other hand, we also wanted to design a realistic plan. We wanted a plan that is not predicated on new government debt, or new taxes, or unrelated outlay savings, and we wanted a plan that does not mind a government program that guarantees a safety net, and requires people to do something to prepare for their own future. That is what a public sector is for, and that is why we actually avoided the term “privatization,” which we think is somewhat of a misnomer for this whole concept. This puts us on the realistic side of those who dream about utopia.

Specifically, we wanted to base the plan on very conservative assumptions about the likely response of our economy. We wanted the plan to avoid any financial slight of hand, such as having the government play the spread between the returns in debt and the returns on equity. We wanted to avoid assuming that magical gains in economic efficiency would suddenly pay our way. We also wanted to avoid shunting the transition costs into the future onto today’s younger generations, or onto unborn generations, or onto some other part of government.

In fact, we wanted the plan to guarantee that the transition costs would require neither an increase in any year in total federal debt obligations nor any increase in any public fee or tax unrelated to the Social Security system.

And finally, we wanted the plan to pass the criterion of what might be called interruptibility, meaning essentially that starting this plan would move us, socially and economically, in a desirable direction, even if we had to stop the plan before it was fully implemented. Much of the discussion I have seen of Social Security reform does not take this into account. In fact, no plan having to do with Social Security, including the original 1935 act, or the 1939 act, and perhaps not the 1983 act, has ever come fully to fruition as the people who designed it planned. History changes. Politics change. All kinds of things change as the world moves on.

What is very important to understand is that, rather than, for instance, putting into stone the unfunded obligations of today’s young, before starting to pay them off in the future, we should make sure that we aren’t digging a deeper hole before we start climbing out of it. And one of the things that our plan does is increase national

savings in every year and also decrease the unfunded benefit obligations in every year. It puts our economy on a more fully funded or investable footing than otherwise.

■ Questions about Modeling

Let me make a couple of other points concerning the modeling question. How do you model Social Security reform? What kinds of modeling questions are important here?

I think the interruptibility question is vital. Another thing that we have been very concerned about in looking at other plans is what I call the *ceteris paribus* standard: All other things being equal, we need a standard by which we can compare one reform plan to another, and what that means is that you can’t simply say, “Well, then there are the transition costs,” right? I have an ideal plan, and then there are five generations that have to get there, but we don’t want to talk about that. You have to be able to describe very explicitly who is going to absorb these costs in a way in which these different plans can truly be compared. We have tried to do that totally within our system. We don’t try to do anything outside the system.

Finally, the savings, productivity, real wages link is absolutely essential. It is this link that keeps Social Security reform from turning into something close to a zero sum game. In fact, as I’ve been pointing out occasionally to the Employee Benefit Research Institute, it even changes the whole meaning of the benefit/payback ratios.

Think about it. If productivity starts improving—say significantly—5 to 10 years after a system like this is implemented, 30 or 40 years from now, productivity or real wages will be quite significantly higher. This means the same labor effort in Social Security contributions is going to produce a much greater payback, because it’s going to be worth more in dollars.

This is the money-back twist that is very often not considered in the way these calculations are done. It is easy to do money-back calculations if you consider that productivity is going to be the same in all the various scenarios. But once you start considering an entirely different economic trajectory, particularly after 40, 50, 60 years, you have to revise your whole thinking about payback ratios.

■ Conclusion

Susan Dentzer¹ asked why we discuss Social Security rather than Medicare? After all, Medicare has future liabilities that are three times as large. Thus, could it be because, in Social Security, there's a killing to be made by certain Wall Street firms, and so forth.

¹ See Susan Dentzer, "Social Security Reform: Gaps in Perception," in this volume.

Personally, I would absolutely love to talk about Medicare at the same time as Social Security. My problem throughout my history of involvement in these issues is that I was always told, by people who didn't really want to do much, that Social Security and Medicare were two entirely different problems, and we could never talk about them together. In fact, all of these different entitlement problems were like so many hardened silos, if you know what I mean.

17

A Retirement System for the Future: Personal Security Accounts

by Ann L. Combs

■ Introduction

I would like to discuss my reasons for thinking that moving in the direction of a partially privatized Social Security is the correct direction for the country and merits serious thought and attention.

I do not begin to deceive myself that we have thought through, or solved, all of the issues and the problems. They are very real, and I think the modeling that Martin Holmer and Jack VanDerhei are doing with the Employee Benefit Research Institute is really essential, because partial privatization of Social Security would represent a fundamental change in the way we deliver retirement income, and we need to work together to answer all these questions. But it certainly is an issue that is worth debate and discussion.

When the Advisory Council on Social Security began our deliberations, we were faced with a dilemma. There are no easy choices; there is no simple solution, or painless option. We are faced with a program that is about 25 percent to 30 percent underfunded over the long term. There was a strong reluctance to raising payroll taxes, both for economic reasons on the part of several members and for political, realpolitik reasons on the part of others.

We started in 1994, a long time ago. At the time the Council was considering payroll tax options, no one believed that the report would be taken seriously if substantial payroll tax increases were a key element.

I am referring to substantial payroll tax increases that would be imposed to continue paying benefits under the current system. A distinction should be drawn between taxes that fund the current pay-as-you-go system and taxes that finance a transition to a new, substantially funded, system.

In addition to opposition to payroll taxes, there was also legitimate and grave concern about

the kinds of benefit cuts that would be necessary to solve the equation without any additional revenue coming into the system. We all shared those concerns. As a result, the Council started talking about the whole notion of investment in the private sector as a way to increase the trust funds' investment return, as opposed to draconian cuts in benefits or raising payroll taxes.

Five members of the Council support the personal savings account (PSA) approach. Frankly, I personally backed into supporting it. Once we started talking about investments in the private sector as a way to solve this dilemma, I simply could not get comfortable with the notion of centralized investment by the federal government in the private markets, and so, firmly believed that the more we can decentralize that aspect and put it under individual control, the better it would be from an economic perspective, and from a political perspective.

The PSA approach was developed for very valid policy reasons.

■ The Personal Savings Account Plan

The PSA plan works as follows. We would gradually transform the current Social Security system into a two-tier system. The first tier would be a flat dollar benefit that would go to all workers, and would be financed on a pay-as-you-go basis. The second tier would be an individual account, a PSA, financed with 5 percent of the current payroll taxes. It is a reallocation of the current payroll tax.

Workers would own their individual PSAs. They would be able to invest in a wide range of financial instruments of their own choice. They could withdraw assets from the PSA only after age 62. I agree with all the comments about the danger of people spending down their account balances if

early access is allowed, and I recognize the political difficulty of walling this money off. I believe it is essential that the assets in a PSA be preserved for retirement. This is an important issue that requires further discussion. These accounts would be an essential part of Social Security. They are different from individual retirement accounts (IRAs). PSAs should be inviolate until age 62.

In addition, our plan does not require annuitization of the account balances. Annuitization is an option, but it is not required. As a result, any balance remaining upon death could pass to one's estate.

Another thing that is important to keep in mind is that the new system would not affect anyone over age 55. It would be phased in very gradually for people between age 25 and age 55, and only those under age 25 would be fully under the new system.

We make some changes that apply across-the-board: raising the retirement age, repealing the retirement earnings test, and changing the taxation of benefits. But the fundamental restructuring of the system is phased in slowly, and everyone over age 55 is grandfathered in the current structure.

■ The Flat Benefit

The advantage of the first tier of our plan—the flat benefit—is that it is the safety net. It provides the basic floor of protection. It is an indexed annuity. It redistributes benefits, very substantially, from high-paid to low-paid workers, and I think that is an important feature of the Social Security system that we should not lose.

And in some sense, it shields low-wage workers from some of the risk of the private-sector investment, because more of their retirement income, relatively speaking, would come from the flat benefit. High-wage workers are going to be more dependent on their individual accounts, which is probably appropriate, considering the risk.

That being said, I want to comment on the specifics of the flat benefit. The dollar amount of the benefit has been criticized as being inadequate. In the proposal, it is \$410.00 a month, which is about two-thirds of the poverty level. That is a low benefit. It is what we could afford to do with the 7.4 percent of the payroll tax that is being used to

finance both that flat benefit and the disability benefits. It also is designed to provide a safety net, supplemented by the account balances in an individual's PSA.

It needs to be made clear who would receive the flat dollar benefit. First of all, no one over age 55 would be affected. As I have said, they would be grandfathered. People between age 25 and age 55 would receive a blended first-tier benefit. They would receive a portion of what they are entitled to under current law, based on how long they have worked under this system, and a portion of the flat dollar benefit.

While the system is being phased in, the flat dollar benefit would be indexed for growth in wages, so that by the time the people who are now under age 25, those who would be fully under the new system, retire, that benefit is projected to be equal to \$629.00 in 1996 dollars. This is because real wage growth is expected to outstrip inflation. Thus, the present value of the benefit would grow over time. Also, once an individual retires and begins drawing benefits, the flat benefit would be price-indexed to reflect the cost-of-living, just as Social Security is today.

Moving on: what are the benefits of the individual account portion of the PSA plan? The most fundamental is that it would replace a system of unfunded benefit promises that is using current workers' taxes to pay for current retirees with a system in which each generation is responsible for saving for its own retirement.

It is fundamentally different from either of the other two approaches recommended by the Council. At the end of the day, under the PSA plan, we end up with a benefit that is 50 percent funded for each worker. I think it creates a very direct link between the taxes that are paid and the benefits that are received, eliminating some of the complexity of the current benefit formula, making it more transparent so that people understand what is going on, and also eliminating some of the labor market distortions.

This approach would minimize the sensitivity of a significant piece of the system to demographic changes, because participants are not going to be dependent on future workers, and how many of them there are, to support them in their retirement. It reduces the current system's incentives to retire even though you may still be productive. The

defined contribution portion of the benefit, in other words, is neutral with respect to the decision to retire.

It would allow individuals and their families to be more involved in a financial decision that affects a critical part of their lives. This could have some secondary effects. I think the presence of individual accounts would serve to increase financial literacy, which is good for the economy as a whole. It could encourage additional savings. If people can see what compound interest does, it might also encourage those with small savings amounts to start saving on their own. Many people don't have 401(k) plans, and this might provide a method for them to see the value of saving, and perhaps to supplement PSAs with additional savings. There is a question of whether there would be substitution; people would put less money in their 401(k)s or other savings vehicles, because now they have to put it in a PSA. This substitution effect would be minimized under approaches such as ours, however, because we are reallocating existing payroll taxes rather than imposing new mandatory savings.

We have talked a lot about economic growth. I believe that increasing savings—real savings in the economy—can improve economic growth, and that, in fact, is the way to deal with the entitlement problem.

■ Transition Costs

Some of the criticism of our proposal concerns an issue that reminds me of the elephant in the middle of the room that everybody's trying to ignore: the transition costs of moving to a privatized system. People have asked, "What is the difference between a 1.52 percent payroll tax to finance the transition and an additional 1.6 percent payroll tax to fund an individual account?" The answer is that it matters where you end up. Under the PSA plan, there would be a much smaller pay-as-you-go system and fully funded defined contribution plan accounts that participants own. The individual account plan results in a very large unfunded pay-as-you-go program financed with 12.4 percent of payroll and small individual accounts.

Our transition tax is not a new payroll tax going to fund the current system and the current level of benefits. It is a very different system; and

that is a distinction about which people need to be educated. It is very important.

I am proud of the fact that we at least tried to address the transition problem. I think people have tried to hide the pea a little bit in this debate, and that is not honest. The transition costs are real and they are very substantial. And, as you know, it occurs because some generations are going to be asked to start paying for their own retirement in addition to continuing to pay for current retirees.

According to Social Security, the system is projected, over the next 75 years, to pay \$18.6 trillion in benefits. In contrast, the current reserve and income taxes are equal to \$9.8 trillion. In other words, you can think of it as an unfunded liability of \$8.8 trillion. What we are doing is taking that implicit federal debt—and it is a debt we owe—and making it explicit. The 1.52 percent is the equivalent payroll tax increase that the actuaries estimate it would take to retire that debt.

We have tried to finance the transition with a combination of payroll taxes and federal debt. The debt is issued to smooth out the cash flow, because the costs are much higher in the early years during the baby boom generation's retirement and drop in later years. The debt is used to smooth out the payments. We finance the transition over two generations, over 70 years. Frankly, all the members of the panel would prefer to see a consumption tax, or some other combination of reduced federal spending, as opposed to payroll taxes. But for purposes of analysis, that is what we went with.

It is important to note that these are estimated costs, and worst-case estimates at that. They do not assume any economic growth as a result of any of these savings. They also do not assume any secondary economic feedbacks. They are just estimates. We do not know for sure that 1.52 percent of payroll will be necessary to fund the transition.

■ Risk

On the issue of risk, I don't accept the notion that workers are not capable of investing for their own retirements. I do believe we need a much greater education effort, and we need to give people the tools they need to learn.

I think the IRA/401(k) experience has been positive. It is important to remember, again, the individual accounts in our proposal are only

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available to people under age 55. There is a lot of the anecdotal evidence about “my mother, my grandmother.” I would not want my mother to try to invest on her own at this point, either. However, I think most people under age 55 have had investment experience through their employers, and others will rise to the occasion.

There is a wealth of information available. I think the interest of the financial markets in this area will have a good effect, in that they will be inspired to bring more information to bear to make this work. On the administrative costs issues, I also think that Wall Street will contribute a great deal to the debate. They have been very creative in solving problems with respect to multiple accounts and small dollar amounts in other areas, and can help develop solutions to those challenges in this arena as well.

I also believe giving individuals real ownership rights is important. We should not forget that there is a vulnerability in the current system, a political vulnerability, over which people have no control. There is risk in investing your own money. There is also risk in the current system. We know benefits are going to be cut, or taxes are going to be increased. The status quo—the true status quo—is not an option. And that is a risk over which people have no control and for which they cannot plan. So I don’t think it is fair to say that there is no risk in the current system.

■ The Government as Investor

Concerning the maintenance of benefits approach, I have fundamental problems with the government

directly investing in the private markets. I would point out that all of the analysis in the Council’s report is premised on the fact that, eventually, up to 40 percent of the trust fund would be invested in a private passive equity fund. Eventually, the government would control \$1 trillion of Social Security assets invested in the private sector.

I appreciate the efforts that proponents of this approach have made to build fire walls and talk about fiduciary duties, but in the end it is politicians who make the decisions and who can rewrite those rules. I believe the temptation for social investing, or targeted investing, or whatever you want to call it, would be too great, whether it is direct investment or actively managing the index through decisions to include or exclude certain companies from the “passive” index.

I also think there are inherent conflicts of interest with the government investing in regulated industries. I think the corporate governance problems are very real, and cannot be avoided. I think government investment would introduce another element that would take away from fiscal discipline, because it would be too tempting for Congress to fiddle with the rate of return assumptions, or the asset allocation model, rather than deal with the difficult issues we face in designing a retirement system for future generations.

■ Conclusion

I believe that moving toward a system of individual accounts, where individuals have true ownership, true control and responsibility, is the superior direction.

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The Case for Incremental Change

by Stanford G. Ross

■ Introduction

Three issues are very much in the public's mind: Medicare, tax reform, and Social Security. The latter probably would be in third place in terms of the likelihood of attracting presidential and congressional attention in 1997. Medicare poses an immediate and huge crisis. Tax reform has been a festering issue, as shown by the Clinton Administration's targeted tax cuts, Republican presidential candidate Robert Dole's 15 percent across-the-board cut, and the tax proposals within the Republican Party's Contract with America. We need to remember that the way in which Medicare and tax reform issues develop may well influence the way we look at the issue of Social Security.

If one assumes that any Medicare solution will absorb any available resources (and indeed, Social Security will be lucky, if the past is prologue, not to lose some of its payroll tax support to solving Medicare's problems), and if one assumes that tax reforms will not undermine the employer deduction for health care or pension contributions, so that you pretty much can deal with Social Security the way it looks now—which I think is a big premise—then the question is, what ought you to do? I do not believe that a program that basically has operated reasonably well over 60 years needs to be radically changed; it needs to be incrementally changed. But it needs to be changed because it should be brought into financial balance, and then it is hoped that a lot of the doomsday rhetoric can disappear.

Particularly among younger age groups, I believe that there is a desire for a more individualized element in the program. They are less accepting of government paternalism. In addition to that, you somehow have to do a number of things at once if you want to strengthen Social Security.

If you take the 12.4 percent payroll tax, and hope that you can maintain that for Social Security, what does that mean for the future? There are all

kinds of ways to look at this, but one way is simply to look at the average replacement rate now used in future calculations. The average replacement rate in Social Security today is roughly 42 percent. Under current law, without any changes, that rate will decline by 2030 to about 36 percent, mainly due to the raising of the retirement age to 67. And then if you try to remedy the 2.15 percent shortfall, you will end up with a Social Security system in balance, with roughly a 30 percent replacement rate.

Within that parameter you might make it more efficient. You might make sure that you truly are protecting lower-income workers, but I would go ahead and take the changes that the "maintain benefits group" had, plus some more, and try to do, in effect what Chairman Edward Gramlich's plan tried to do: bring Social Security into balance within the existing payroll tax.

I do not favor the proposal to invest the reserves in the equity markets because that type of direct investment introduces all sorts of political risks into the system. Even countries as committed to public pensions and democracy as Sweden and Japan have had political difficulties with that kind of approach. Further, even if one Congress might do it right, another Congress might do it wrong. I also disagree with those who believe that a direct-investment approach will appeal to younger workers. Their involvement is too remote; they would see it as the government doing the saving, not themselves. It would look to them very much like the government bonds that are there now.

■ A Case for the Voluntary Approach

So how should we begin? I would urge consideration of a voluntary approach. I would begin to undertake the massive public education that is

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required by creating a program to include institutionalized education. For example, on a voluntary basis, people could put, say, 2 percent, with tax incentives, into an individual account that would be an add-on to Social Security.

The bill sponsored by Sens. Alan Simpson (R-WY) and Robert Kerrey (D-NE) had something like this in its elective feature for the 2 percent. The problem with that bill was that when you got the 2 percent out of the existing 12.4 percent, the remaining 10.4 percent did not leave enough room for a Social Security program that maintained the traditional values and structure of the program. And for that reason, I do not believe that the remaining Social Security program under the 5 percent approach that was described leaves a Social Security program that would have popular support or long-term viability. But I believe you could have a viable Social Security program within the full 12.4 percent. If the public were to decide they wanted a larger program, taxes would have to be increased at that time to pay for it.

Voluntary worker participation would demonstrate the desire for savings. The program should be made coterminous with Social Security. Unlike existing individual retirement accounts (IRAs) and 401(k)s, there should be no option to withdraw savings early for education, medical emergency, etc. It should be available only when Social Security benefits are available. So it would be savings locked up strictly for retirement.

This approach allows people to vote with their pocketbooks, if you will. Those in the younger generations who want to save more can save more, and those who do not will have passed up the opportunity but still will have Social Security. In short, I believe we ought to be looking more at a voluntary approach to develop an additional pillar of savings. In that way, the basic Social Security program remains in place for those who invest their money imprudently or are unfortunate. Similarly, you might need a lot less government regulation than would be required with a mandatory program. As with IRAs and 401(k)s, some restrictions

probably would have to apply, but there would be a lot fewer restrictions than if it were a mandatory program.

I also have considered providing some greater incentives by perhaps including an employer-matching element or some sort of matching out of existing tax sources. Lest you think I am a backdoor spender by proposing these tax incentives, I assure you that there are plenty of existing tax expenditures we could recapture and use to pay for this purpose. So this would have no net impact on the budget.

I have not had the time that the three groups on the Advisory Council have had to work through this “add-on” voluntary approach, but I think that it has some appeal because it gets you started in a direction that meets with a lot of enthusiasm. And that enthusiasm is not restricted to Wall Street people who create and sell products. I believe younger people are interested in these issues in a different kind of way than their elders, and this could be a vehicle for encouraging younger people to increase savings.

Any changes here are going to have to be broadly bipartisan and based on a great deal of public education. Different people make different calls on the economics and the politics and how they think people react to things. One advantage of a voluntary approach is that it would elicit valuable feedback about how the people who would be affected feel about putting away more for their retirement.

■ Conclusion

Even the best models in the world will not give us the kind of answers we want, because no matter how detailed and complicated you make them, they never will fully mirror the way people will react. That is why it would be wise to have a program that began to provide some real-life experience with these very difficult issues of increasing savings for retirement.

Keeping Track of Social Security Reform Proposals: A Summary

by Kelly Olsen

■ Introduction

Among many policymakers across the political spectrum, there seem to be two main points of consensus about Social Security. The first is the necessity for reform. The second is that reform ought to involve private market investment of retirement taxes¹ and/or of national defined contribution-style savings in order to give taxpayers a better return on their money than the current system affords and thereby reduce national retirement program costs. Here agreement stops and debate about specific reform packages begins.

The Social Security Trustees stated in their 1996 annual report that, under intermediate assumptions about the economy and demographics, Social Security will be unable to meet its promises to beneficiaries by 2029. At this date, the trust fund surplus will be exhausted, and FICA tax revenue alone will be able to provide only 76 percent of benefits payable.²

Social Security surpluses are invested in U.S. Treasury bonds, which are projected to provide rates of return that exceed inflation by 2.3 percent.³ This is a low rate of return relative to the average above-inflation yield of about 7 percent on equities over the past several decades.⁴ Proponents of private market investment of retirement taxes and/or of national defined contribution-style savings reason that investing in the equities market will provide better rates of return and thereby lower program costs. Some also believe switching retirement tax investment into the private sector will increase net savings and provide capital to spur economic growth. Advocates of allowing or mandating defined contribution-style savings within the national government retirement system similarly cite economic growth and increased savings as primary advantages.⁵

■ Reform Proposals

Although many policymakers seem to agree that private investment of retirement taxes in equities will be part of any reform, exactly how to invest and to what extent has been a topic of hot debate. For example, the 13-member 1994–1996 Social Security Advisory Council was assembled by the Secretary of Health and Human Services to propose a solution to the program's financing needs. This highly factionalized council recently released a much anticipated report delineating three reform packages, each proposing different means of investing varying proportions of retirement taxes in the equities market. In fact, dissenting views are expressed even among supporters of the same reform packages. Meanwhile, other reform proposals have been forthcoming from both legislators and public policy organizations.

As a result of the multitude and complexity of the reform plans, it is difficult to stay abreast of the debate. To provide a broad summary of these reforms, table 1 shows a point-by-point comparison of seven major Social Security reform packages. Keep in mind that some of the complexities and caveats of these reforms have been pared down in order to create a summary and that these plans may continue to evolve as the debate progresses.

This table includes the best information available at this time. A request for verification of the table's content was sent to each reform sponsor and to several plan supporters. A number of plan sponsors and supporters responded, and every effort was made to incorporate their revisions and suggestions. The author welcomes additional information and comments from readers.

■ Endnotes

¹ For the purposes of this article, the term retirement taxes only refers to revenue that is deducted from workers' payroll earnings for the purpose of funding a national retirement program.

² "Actuarial Status of the Social Security and Medicare Trust Funds," Social Security Bulletin (Summer 1996): 61.

³ Henry Aaron "Behind the Privatization Rush," Washington Post, July 22, 1996, p. C1.

⁴ *Ibid.*

⁵ For example, Jose Pinera of the Cato Institute attributes Chile's increased savings rate of 26 percent of gross national product and its economic growth rate of 7 percent, double Chile's historic rate, to Social Security privatization (Jose Pinera, "The Success of Chile's Privatized Social Security," Cato Policy Report (July/August 1995): 10. In addition,

Sylvester Schieber, co-sponsor of the Personal Security Account Plan, states his plan would "turn our Social Security system into a major engine of real savings for workers so they can both secure their own retirement income needs while also making a contribution to the future growth of the national economy" (Proposals for Retirement Policy Reform: Ensuring Our Workers' Retirement Security, Testimony before the Senate Labor and Human Resources Committee, Aging Subcommittee, July 16, 1996).

Appendix A: Table 1

A POINT-BY-POINT COMPARISON OF SOCIAL SECURITY REFORM PLANS

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM PLAN
TYPE OF PLAN	Defined benefit (DB)	DB and defined contribution (DC)	Phase out one-half of existing DB system; replace other half with a DC system. Remaining DB part of system is restructured to provide a flat benefit for all participants.	DC with a redistributive component (see below) for low earning workers and a minimum retirement income guarantee; all OASDI "elder" benefits (i.e., benefits for retired workers, aged spouses and widow[er]s) are phased out.	DB and DC	DB and variable DC, with decline in DB as DC component of new system grows.	DB and DC
INVESTMENT PLAN							
PRIVATE MARKET INVESTMENT?	Possibly	Yes	Yes	Yes	Yes	Yes	Yes
WHO INVESTS?	Federal government	Individuals	Individuals or their designated broker or financial institution	Individuals; government is default investor for those unable or unwilling either to manage their own funds or to hire a financial manager to do so.	Individuals and federal government	Individuals	Individuals
INDIVIDUAL ACCOUNTS	No	Yes, called individual accounts (IAs)	Yes, called personal savings accounts (PSAs)	Yes, called personal thrift accounts (PTAs)	Yes, called personal investment plans (PIPs)	Yes, called personal retirement savings accounts (PRSAs)	Yes, called personal retirement accounts (PRAs)
INDIVIDUAL PARTICIPATION	None	Mandatory	Mandatory for workers under age 55 in 1998	Mandatory, with allowance for extra voluntary contributions	Optional in S. 824; mandatory in S. 825	Optional	Mandatory
WHERE IS INDIVIDUAL ACCOUNT HELD?	Not applicable	Like the Federal Thrift Plan, accounts are held by the federal government, but are separate from federal government assets and are not used in calculating the federal debt.	In private institutions designated by workers	Individuals place in private market	U.S. Treasury; like Thrift Savings Fund, some PIPs allowed in IRA ^b -type accounts. Administered by banks, credit unions, or other institutions subject to banking laws.	Individuals place DC account in private market.	Privately owned and held

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERRY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM
USE FICA REVENUE FOR INVESTMENT?	Yes; invest part of trust fund accumulations that would otherwise be invested in U.S. Treasury bonds; gradual investment until 40% of trust fund accumulations are invested in private market securities by 2014.	No	Yes; invest 5 percentage points of the non-Medicare FICA rate (12.4%), paid only by the employee (remaining 7.4% used to finance the flat benefit, as well as survivors, spouse, and disability benefits).	Yes; any annual OASI operating surplus is credited, pro rata, to workers' PIAs.	In S. 825, yes; invest 25% of annual trust fund accumulations and 2% of employee's share of non-surplus, non-Medicare FICA; in S. 824, government does not invest trust fund accumulations, but 2% of employee's share of non-Medicare FICA is put into PIPs on an optional basis.	Yes; invest trust fund accumulations over 1 year's worth of benefits; specific % available for investment is based on how much people take in Social Security DB benefits, affecting how much surplus there is under 12.4% FICA; how much people take from DB part depends on accumulation rates in PRSAs; percentage of surplus available for investment is expected to be 2.3% for 1998.	No
INCREASE PAYROLL CONTRIBUTIONS?	Yes; 0.8% on employers and employees (1.6% additional tax overall) beginning in 2045; non-Medicare FICA would then equal 14.0% total. The MB plan would increase contributions by 0.15 percent on the employee's covered wages, to be matched by the employer only if it did not change the computation period.	Yes; 1.6% on employees in 1998. DB part remains financed by 12.4% FICA; total FICA in 1998 would be 14.0%	Yes; by 1.52% on employers and employees for 70 years, beginning in 1998, to help finance the transition.	No, current law FICA remains initially unchanged; once OASI operating surpluses exceed 3% of payroll, FICA taxes are reduced. However, workers are required to contribute 5% of their earnings to PIAs (no employer contributions); contributions of low earners are matched by the government, with the subsidy phased out at three times the low wage threshold.	No	No	Yes, by 1.5 percentage points for both employers and employees. However, government receives no additional revenues.
PROPERTY OF BENEFICIARY'S ESTATE UPON DEATH?	Not applicable	To spouse as if joint annuity	Yes	Yes	Yes	Yes	Yes
TAX TREATMENT OF INDIVIDUAL ACCOUNT BENEFITS	Not applicable	Employee contributions are after tax, while distributions are free of federal income taxes or tax deductible when saved and taxable when benefits are paid.	Individuals' contributions to PSAs are after tax, so distributions are tax free.	PTA contributions and capital accumulation are exempt from personal income taxation; distributions are fully taxable.	Like an IRA, PIP contributions and accumulations are tax free until distribution.	Contributions are not taxed; distributions are taxed same as Social Security income rules.	Like a 401(k)—contributions and earnings are tax free until distribution

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CEC REFORM PLAN
INVESTMENT RULES	If private investment, in corporate bonds and equity index funds.	Based on Federal Thrift Savings Plan—choose from a list of index funds administered by the Social Security Administration (SSA).	Assets are invested at the discretion of the worker but subject to regulations restricting them to retirement purposes and to investments in widely held financial instruments.	Federal oversight board determines % of assets required in risk-free debt and establishes diversification regulations; individuals select a certified financial manager of their choice, except that a federal board invests for workers unable or unwilling to do so themselves.	Based on Federal Thrift Savings Plan; option of two wide investment categories: (1) personal investment plan with low, moderate, and high risk options, and (2) IRA-like accounts with investment options exactly like current IRA options.	Similar to current IRA options, assets are invested at workers' discretion in U.S. securities, insurance contracts, certificates of deposit, common stocks, and/or other instruments or obligations selected by qualified professional asset managers.	Assets are invested in a limited number of broad-based funds that may invest in private-sector financial securities, government debt, etc.
FORM OF DISTRIBUTION RULES	Not applicable	Mandatory minimum indexed annuity upon retirement, (mandatory joint if married unless spouse signs a waiver) issued under SSA rules and underwritten by the government.	Optional annuitization with withdrawal limits based on remaining life expectancy (not final)	Mandatory annuitization of minimum annuity; full freedom with remainder of funds	Assumed mandatory annuitization because of modeling after Federal Thrift Plan, but no explicit information found	?	Funds must be withdrawn gradually over life after retirement or annuitized
PRERETIREMENT LOANS?	Not applicable	No	No	No	No	Undecided, but probably not.	No
ACCRUAL OF ADDITIONAL FEDERAL DEBT REQUIRED?	No	No	Yes, in addition to the 1.52% tax increase, "liberty bonds" would be issued by the federal government from 2002 through 2069 to finance the transition to the new system. Liberty bonds would equal about \$650 billion by 2030 and be repaid with the proceeds of the transition tax of 1.52%. Liberty bonds would be equal to 1.97% of taxable payroll annually.	Yes, a slight initial increase in the deficit would peak at \$45 billion (or 0.4% of gross domestic product [GDP]) in 2006; by 2014, this deficit turns into a surplus.	No	No	Federal debt reduced in the future by making DB plan solvent.
AMOUNTS EXPECTED TO BE ALLOCATED TO INDIVIDUAL ACCOUNTS	Not applicable	Approximately \$50 billion annually/ \$1.2 trillion by the end of 2015 (1996 dollars)	Approximately \$3.3 trillion by the end of 2015 (1996 dollars)	Net annual savings in PTAs rises from 1.7% of GDP in 2000 to 3.4% of GDP by 2030	In S. 825, 2% of non-Medicare FICA; S. 824, optional, so allocation depends on behavioral response to PIP option.	\$2.33 trillion by 2015	More than \$100 billion annually, accumulating to \$2.5 trillion by 2015 (1996 dollars)

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM I
EXPECTED INCREASE IN NATIONAL SAVINGS?	Not applicable	?	?	Raises net national savings by 2.6% of GDP by 2010 and by 5% of GDP by 2030.	No data found on S.825; S.824 is actuarially neutral.	?	Large increase anticipated; full amount is unknown
HOW MUCH NET ADDITIONAL REVENUE IS EXPECTED TO FLOW INTO STOCK MARKET ANNUALLY IN 1996 DOLLARS?^c	Approximately \$25 billion on average	Approximately \$20 to \$25 billion on average	Approximately \$75 billion on average	Roughly one-half of PTA assets; 0.85% of GDP annually in 2000 rising to 1.7% annually by 2030.	?	\$78.1 billion in 1998; average per year 1998 through 2015 is \$129.5 billion.	Approximately \$1 billion on average
HOW MUCH NET ADDITIONAL REVENUE IS EXPECTED TO FLOW INTO PRIVATE CAPITAL MARKET BY 2015 IN 1996 DOLLARS?	\$1.1 trillion by 2015	\$600 billion by 2015	\$2.1 trillion by 2015	Total expected value of privately invested plan assets by 2015 is approximately 35% of GDP, rising to 55% of GDP by 2030.	?	Majority of PRSA balances expected to go into private capital market (see above).	\$1.1 trillion total
OFFSETTING REDUCTION IN SOCIAL SECURITY BECAUSE OF PRIVATE INVESTMENT	Not applicable	Not applicable	No "offsetting" reductions, but note that workers aged 25 through age 54 in 1998 would receive a benefit that is a combination of the existing current-law defined benefit and new fiat benefit, with amounts prorated to reflect time covered by old and new systems.	OASI "elder benefits" are gradually phased out by reducing newly earned wage credits used in calculating future benefits.	In S. 824, PIP accumulations are offset with corresponding reductions in bend points so that the plan is actuarially neutral.	For PRSA participants, present value of expected lifetime Social Security benefits is reduced by the present value in the PRSA, discounted at a rate of 4.3%	None
MISCELLANEOUS REFORMS							
REDIRECT SOCIAL SECURITY TAX REVENUES FROM MEDICAID PART A HOSPITAL INSURANCE (HI) TO THE SOCIAL SECURITY TRUST FUND?^d	Yes, at the time Medicare is refinanced; note that redirection would amount to a reduction in HI funds equivalent to 0.31% of taxable payroll.	No	Yes; immediately; note that redirection would amount to a reduction in HI funds equivalent to 0.31% of taxable payroll.	No	Yes; note that redirection would amount to a reduction in HI funds equivalent to 0.31% of taxable payroll.	Yes; note that redirection would amount to a reduction in HI funds equivalent to 0.31% of taxable payroll.	No

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM PLAN
COVER NEW STATE AND LOCAL GOVERNMENT EMPLOYEES?	Yes	Yes	Yes	Possibly	Yes	Yes	Yes
BENEFIT REDUCTIONS FOR FUTURE RETIREES							
RAISE MINIMUM TAXES ON BENEFITS?	Yes, tax under general income tax principles; taxes calculated individually; average taxable income would be 92%. All Social Security benefits in excess of already taxed employee contributions would be included in federal taxable income and the proceeds deposited to the OASDI trust funds. The income of low-wage earners would still be protected, as about 30 percent of Social Security beneficiaries would not pay any taxes.	Yes, tax under general income tax principles; taxes calculated individually; average taxable income would be 92% on DB part; on DC part, contributions are after tax but tax free upon distribution. All Social Security benefits in excess of already taxed employee contributions would be included in federal taxable income and the proceeds deposited to the OASDI trust funds. The incomes of low-wage earners would still be protected, as about 30 percent of Social Security beneficiaries would not pay any taxes.	For all aged 55 or over, one-half of benefits would be taxable; all Tier 1 (db) benefits would be taxable; eliminate the AGI (adjusted gross income) threshold; on DC part, contributions are after tax but tax free upon distribution. The incomes of low-wage earners would still be protected, as about 30 percent of Social Security beneficiaries would not pay any taxes.	85% of all OASDI benefits subject to personal income taxes.	No	Yes, tax as general revenue	Yes, federally tax all benefits from DB portion in excess of contributions made by worker. This would be achieved by making 85% of Social Security benefits taxable income, not by calculating federal taxes individually for beneficiaries.
PHASE OUT INCOME THRESHOLDS?	Yes	Yes	Yes	Yes	No	No	Yes
INCREASE NORMAL RETIREMENT AGE (NRA) FASTER THAN CHANGE MANDATED BY THE 1983 AMENDMENTS (AGE 67 BY 2027)	No	Yes, gradually increase NRA by 2 months annually beginning in 2000 until age 67 for those reaching age 62 by 2011; index to thereafter/projected to be about 1 mo. every 2 yrs.; full benefit NRA equals age 69 by 2059.	Yes, gradually increase NRA by 2 months annually beginning in 2000 until age 67 for those reaching age 62 by 2011; index to thereafter/projected to be about 1 mo. every 2 yrs.; this rate of increase to be reviewed every 10 yrs. by Congress.	No	Yes, to age 70 by 2029 (S. 825); indexed to longevity thereafter.	Yes, in 2002, NRA rises by three months per year until age 69 in 2000 to 2018, indexation thereafter to longevity.	Yes, raise NRA by 2 months each year until it reaches age 70 in 2030.

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM PLAN
INCREASE EARLY RETIREMENT AGE (CERA)?	No	No	Yes, gradually increase to age 65 in the year 2035 for DB part (not indexed) but DC part could be drawn on as early as age 62.	No	Yes, incremental increases beginning in 2002 until ERA is 65 by 2017, index after 2030.	Yes, gradually to age 65 from 2000 through 2011; tracks NRA to longevity after 2015, but four years behind.	No
REDUCE COST-OF-LIVING ADJUSTMENT (COLA) BY REDUCING CONSUMER PRICE INDEX (CPI)?	No, but assumes the annual CPI is reduced from Trustees' assumptions by 0.21 percentage points, the amount announced by the Bureau of Labor Statistics in March 1996.	No, but assumes the annual CPI is reduced from Trustees' assumptions by 0.21 percentage points, the amount announced by the Bureau of Labor Statistics in March 1996.	No, but assumes the annual CPI is reduced from Trustees' assumptions by 0.21 percentage points, the amount announced by the Bureau of Labor Statistics in March 1996.	Yes, by 0.5 percentage points, the amount announced by the Bureau of Labor Statistics in March 1996.	Yes, by 0.5 % points; limit full COLAs to beneficiaries below 30th percentile; those above 30th percentile get only the COLA amount due those at the 30th percentile.	No	No, but favors improvement of accuracy of CPI measurement beyond already implemented by BLS in 1996 0.21 percent correction.
CHANGE IN BENEFIT CALCULATIONS?	Yes, best 35 years to best 38 ^e years (equals, on average, a 3% reduction in benefits by 1999). The MB plan would either change the computation period or increase contributions by 0.15 percent on the employee's covered wages, to be matched by the employer.	Yes, best 35 years to 38 years, ^e and gradually scale back benefits for earners in the second and third tax brackets by changing formula (1) so that benefits can be financed with current 12.4% payroll tax and (2) so as to preserve current benefit level in real dollars. ^f	Yes, for Disability Insurance (see below); also, the "Social Security" portion (the flat benefit) would now be based on years of coverage, not average earnings; retirement eliminated by 2002.	Annual wage credits for OASI "elder" benefits are reduced by 5% per year so that no benefits are being earned after 20 years; in effect, this amounts to a pro rata cohort reduction in benefits where amount of reduction depends on year beneficiaries were born (or turn age 62).	Yes, change bend points to be more progressive (two different ways to do this in S.824 and S.825)	Best 39 years instead of best 35 years ^e ; also, change bend points to be more progressive.	Yes, slow the increase of the PIA as linked with real wages for all but lower income workers. In addition, calculate from best 40 years rather than best 35 years. ^e
REDUCE SPOUSAL BENEFITS?	No	Yes, to 33% of PIA (also see survivor's benefits).	No, spouses would receive the higher of their own retirement benefit, one-half of their retired spouse's benefit, or one-half of the flat benefit (when fully phased in); spouses would receive proceeds from their own PSAs.	New spousal benefits are phased out over 10 years.	Yes, change from a maximum of 50% of retired spouses' full benefit to 33% maximum.	Yes, change from a maximum of 50% of retired spouses' full benefit to 33% maximum.	Yes, gradually from 1/2 of workers PIA to 1/3.

	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM PLAN
<p>EFFECT ON DISABILITY INSURANCE (DI) AND SURVIVORS INSURANCE (SI)</p>	<p>No change from current law.</p>	<p>Survivor's benefits would be higher of 75% of combined couples benefit or 100% of deceased worker's benefit.</p>	<p>Gradually reduce DI primary benefit payable as NRA increases to ensure DI benefits do not exceed benefits available through early retirement; results in a 30% reduction in DI benefits by 2038 (however, overall DI reductions would never fall below 70% of current law); increase aged survivors benefits (=75% combined or 100% deceased worker's benefit); DI and SI still administered by SSA; no change in young survivors' benefit.</p>	<p>DI is unaffected, except that benefits are fully taxed; SI is phased out except for benefits to children, widowed mothers and fathers, and managed disabled widow(er)s.</p>	<p>No change in DI; surviving spouses inherit PJP accumulations.</p>	<p>Survivors would inherit PRSA amounts; primary insurance amount (PIA)⁹ would not be reduced for people with PRSAs who are disabled and under age 60.</p>	<p>Statement does not address DI.</p>
<p>MINIMUM GUARANTEED BENEFIT TO ALL WHO PARTICIPATE?</p>	<p>No change from current law.^h</p>	<p>No change from current law.^h</p>	<p>Yes, for workers participating for 35 years, equivalent to \$410 per month in benefits (1996 dollars) from Tier I (DB part), indexed by growth of average wages; a smaller minimum benefit for workers participating fewer years; people with only 10 years participation get one-half of full-career worker's benefit.</p>	<p>Yes, all Americans aged 62 and over are guaranteed a total household income equal to 100 percent of the poverty line.</p>	<p>No change from current law.^h</p>	<p>No change from current law.^h</p>	<p>No change from current law.</p>
<p>BENEFIT REDUCTIONS AND/OR BENEFIT TAX INCREASES FOR CURRENT BENEFICIARIES</p>	<p>No change in gross benefits, but net benefits are reduced by implementing new tax rules (see above).</p>	<p>No change in gross benefits, but net benefits are reduced by implementing new tax rules (see above).</p>	<p>Grandfather in persons age 55+ in 1998 but with new NRA, ERA, and tax rules.</p>	<p>One year COLA freeze, with COLAs thereafter set at the CPI minus 0.5 percentage points; 85% of all OASDI benefits are subject to personal income taxes.</p>	<p>COLA changes would apply to current beneficiaries, but no one over age 51 would be affected by age change.</p>	<p>Upper income beneficiaries who have already gotten out of the system what they and their employers contributed have benefits cut; none over age 58 would be affected by NRA/ERA increases; no one receiving spousal benefits before 2000 would be affected.</p>	<p>No change in gross benefits, but net benefits are reduced by implementing new tax rules (see above).</p>

IMPLEMENTATION DATE	MAINTENANCE OF BENEFITS REFORM PLAN (BALL)	INDIVIDUAL ACCOUNTS REFORM PLAN (GRAMLICH)	PERSONAL SECURITY ACCOUNT PLAN (WEAVER-SCHIEBER)	NATIONAL TAXPAYERS' UNION FOUNDATION (NTUF) NATIONAL THRIFT PLAN	PERSONAL INVESTMENT PLAN ACT OF 1995 (S. 824) AND STRENGTHENING SOCIAL SECURITY ACT OF 1995 (S.825) (KERREY-SIMPSON)	THE SOCIAL SECURITY SOLVENCY ACT (REP. NICK SMITH)	CED REFORM PLAN
1998, but investment of Social Security trust fund accumulations would not begin until 2000.	1998	1998	1998	1998	1998	1998	Enacted a.s.a.p. and phased in gradually.
DO PLAN PROPOSITIONS EXPECT PLAN TO RESOLVE 75 YEAR PROJECTED SHORTFALL?	Yes	Yes	Yes	Yes	Yes	Yes	Yes, solves more than 100% of projected shortfalls.

³⁰Old-Age and Survivors Insurance.

³¹Individual retirement account.

³²All numerical data in this row, except for the National Taxpayers' Union Foundation plan, were provided by Steve Goss, Office of the Actuary, Social Security Administration.

³³At present, a portion of Old Age Survivors and Disability tax revenue is allocated to finance Medicare's Part A (Hospital Insurance) fund.

³⁴Currently, Social Security benefits are computed in a formula using the average of a worker's highest paid 35 years of work. This change would include three additional years into this formula. For most workers, chances are the addition of these three years will lower their average and thereby reduce their Social Security benefits, on average, by three percent.

³⁵The 32 percent and 15 percent conversion factors in the present benefit schedule would be gradually lowered over time to 22.4 percent and 10.5 percent, respectively.

³⁶The primary insurance amount is calculated to determine OASDI benefits. This means no benefit formula changes would apply for people with personal retirement savings accounts who are under age 60 and disabled.

³⁷Current law does not provide a specific dollar benefit minimum to all beneficiaries, but it does provide a minimum benefit in that the benefit formula is computed using a special minimum PIA for persons with many years of low wages.

³⁸The CED plan builds in a margin for projection error by identifying benefit cuts sufficient to eliminate the 133 percent of the presently projected 75-year actuarial deficit.

Daring to Touch the Third Rail

by Paul Yakoboski

■ Introduction

Reform of the Social Security system is now the subject of serious discussions in various circles. According to the latest Social Security Trustees' report, cash flow¹ in the program will turn negative in the year 2015, and the existing trust fund will be depleted by 2029, under intermediate assumptions. Under the pessimistic assumptions, these dates are 2000 and 2016, respectively; historically, the pessimistic assumptions have frequently proven to be accurate. Current proposals for reform run the gamut from relatively minor adjustments to the existing system to major restructuring. The Social Security Advisory Council recently released three different proposals for reform, and serious debate is now beginning among policymakers, possibly with the formation of some type of commission to make recommendations.

■ A General Lack of Confidence

According to the 1996 Retirement Confidence Survey, co-organized by the Employee Benefit Research Institute, the American Savings Education Council, and Mathew Greenwald and Associates, both workers and retirees appear pessimistic regarding Social Security, but workers are much more so. Thirty-eight percent of retirees report Social Security as their most important income

source, and an additional 26 percent consider it a major source. By contrast, only 10 percent of current workers expect Social Security to be their most important source of retirement income, and only 16 percent expect it to be a major source. Furthermore, 23 percent of workers do not expect Social Security to be a source of income for them in retirement. Seventy-nine percent of workers are not confident that the Social Security system will continue to provide benefits of value equal to the benefits provided today, compared with 48 percent of retirees who feel the same way.

■ The Public Views Reform

According to the 1996 Retirement Confidence Survey, the public generally opposes reforms that in some sense involve sacrifice, i.e., benefit cuts and/or tax increases. At the same time, the public tends to favor reforms that effectively trim benefits for higher income retirees. The public is also receptive to more dramatic reforms, especially those that hold out the possibility of a "free lunch."

Benefit Cuts and Tax Increases

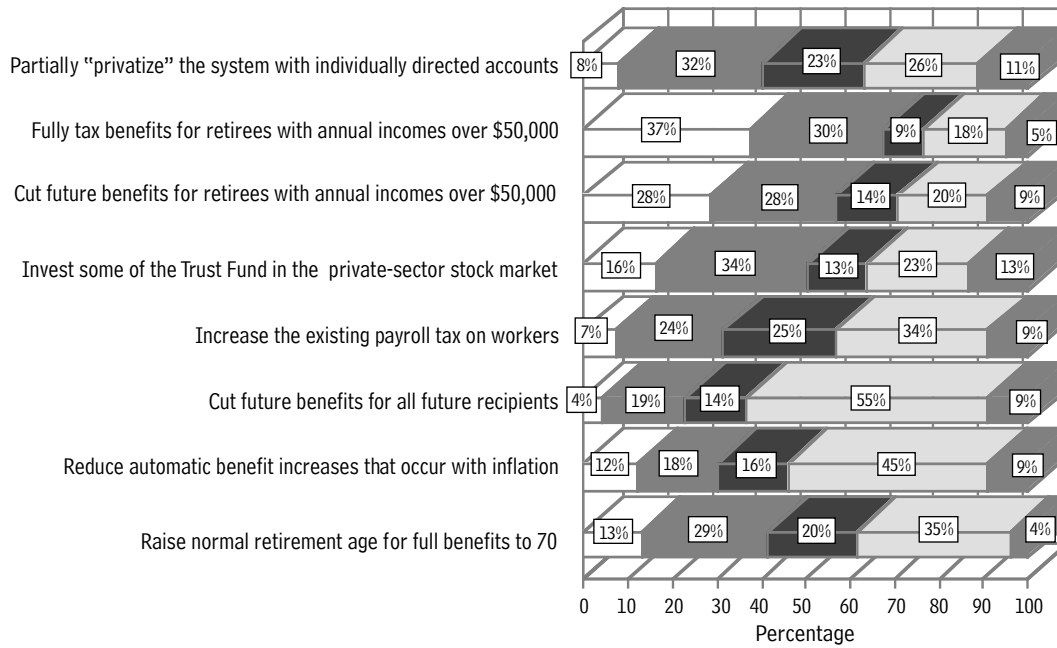
The majority of both workers and retirees oppose any type of benefit cut. Majorities of both groups strongly oppose cutting future benefit payments for all future recipients (56 percent of workers and 55 percent of retirees) (appendix B, chart 1). An additional 22 percent of workers and 14 percent of retirees somewhat oppose such cuts.

Benefits can also be cut indirectly by raising the retirement age and/or by scaling back cost-of-living adjustments (COLAs), benefit increases that occur automatically with inflation. About 60 percent of each group opposes reducing the level of the automatic COLAs that occur with inflation. However, retirees are more strongly opposed to COLA cutbacks than workers; 45 percent of retir

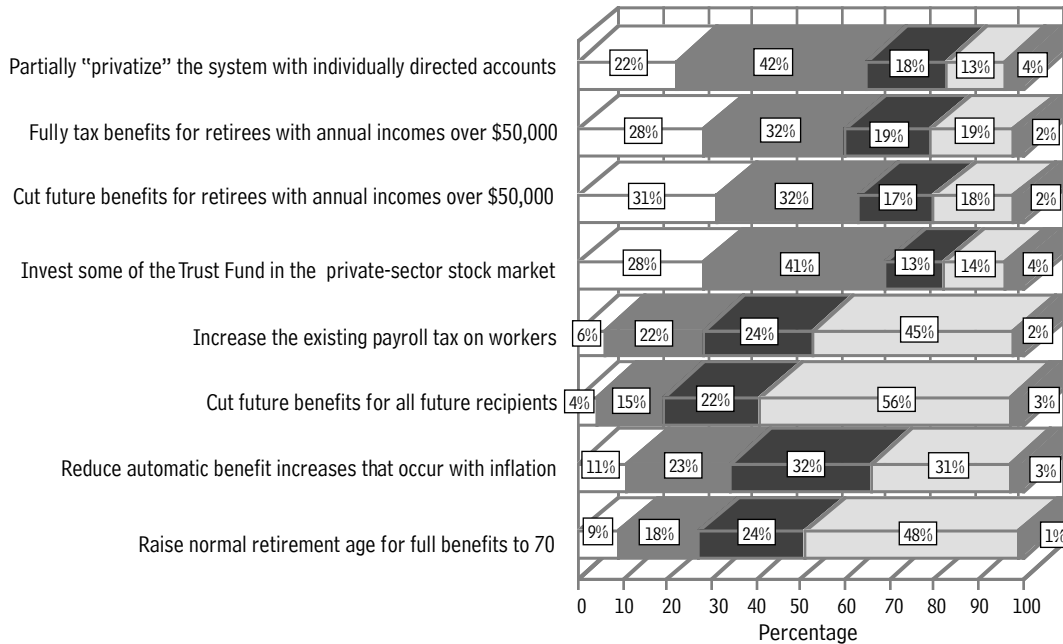
¹ *Cash flow is the difference between program income, excluding interest, and program outgo. Income excluding interest consists of payroll-tax contributions, income from taxation of benefits, and miscellaneous reimbursements from the general fund of the U.S. Treasury. Outgo consists of benefit payments, administrative expenses, net transfers from the Old-Age and Survivors Insurance and Disability Insurance Trust Funds to the Railroad Retirement program under the financial-interchange provisions, and payments for vocational rehabilitation services for disabled beneficiaries.*

APPENDIX B: CHART 1

RETIREES' ATTITUDES REGARDING SOCIAL SECURITY REFORM



WORKERS' ATTITUDES REGARDING SOCIAL SECURITY REFORM



Strongly Favor
 Somewhat Favor
 Somewhat Oppose
 Strongly Oppose
 Don't Know

Source: Employee Benefit Research Institute/Mathew Greenwald and Associates/American Savings Education Council, 1996 Retirement Confidence Survey.

ees strongly oppose such change, compared with 31 percent of workers. Majorities of both groups oppose raising the retirement age, but, not surprisingly, current workers are more strongly opposed. Seventy-two percent of workers and 55 percent of retirees oppose raising the normal retirement age for collecting full benefits to age 70.

In addition, majorities of both groups oppose increasing the existing payroll tax on workers. Sixty-nine percent of workers oppose such reform, with 45 percent strongly opposed. Fifty-nine percent of current retirees oppose such reform, with one-third (34 percent) strongly opposed.

Both groups favor cutting benefits for retirees with higher incomes. Among retirees, 67 percent favor fully taxing benefit payments of retirees with incomes over \$50,000, and 56 percent favor cutting future benefit payments for retirees with incomes over \$50,000. Among workers, such proposals are favored by 60 percent and 63 percent, respectively. Interestingly, even majorities of workers with annual incomes over \$50,000 favor such proposals.

Trust Fund Equity Investment

Respondents were also asked about investing some of the trust fund in the stock market as opposed to keeping it all invested in government securities. Sixty-nine percent of workers favored such change (with 28 percent strongly favoring). One-half of retirees favored such reform. Over the long term, the stock market has historically had greater returns than government bonds. Apparently individuals like the idea of the trust fund earning a greater rate of return than it currently does. In some sense, they are expressing a preference for the proverbial “free lunch,” but they may not understand the short-term volatility that comes with equity investing and what this may mean for the system.

Individual Accounts

Finally, respondents were asked their opinion of a proposal to deposit a fraction of their payroll taxes in an individual account over which they would exercise investment control. Income generated from their account, combined with a guaranteed base

benefit, would then constitute their total Social Security benefit. Benefits could be greater or less than those currently provided under the present system.² This is the one reform proposal on which the majority of workers and retirees disagreed. Sixty-four percent of workers favored such reform, with 22 percent strongly favoring it. Only 40 percent of current retirees favored such reform. Obviously, such reform would not impact those already receiving benefits from the program. The older the worker, the less likely he or she was to support this proposal. Support did not vary notably with worker income levels.

■ Implications

Americans’ opinions regarding the Social Security system are paradoxical. They are generally pessimistic about the current system and its ability to maintain benefit levels into the future. At the same time, they generally oppose any form of benefit cuts (except for higher income retirees) and/or tax increases. What types of changes would they be willing to accept? Apparently, investment of some trust fund assets in private equity markets and the creation of individual Social Security 401(k)-like accounts as part of the system. This is likely indicative of two phenomena: first, a desire for relatively painless solutions and, second, some degree of distrust of the federal government in this area. Workers would be willing to have some of the money in their name and under their control, as opposed to trusting in government promises that are subject to change. This is the environment within which elected officials must tackle the situation.

² The exact question wording was: “Currently, all Social Security taxes in excess of those needed to pay current benefits are invested by the government in government bonds. Some people have proposed that individuals be allowed to decide how some of the money they pay in Social Security taxes is invested. Upon retirement, individuals would receive a reduced guaranteed Social Security payment, but they would also receive income from the investments they chose. The total of these two sources of money could be higher than current guaranteed benefits if the individual’s investments did well or lower if the individual’s investments did not do well. How do you feel about this proposal?”

Public Attitudes on Social Security Reform

by Pamela Ostuw

■ Introduction

Surveys conducted by the Employee Benefit Research Institute and the Gallup Organization, Inc. from February 1990 to March 1995 examined public attitudes on Social Security.¹ Time trends and direct comparison among the surveys are problematic due to changes in question wording or response options. However, the survey results do provide some insights into attitudes toward Social Security and how these attitudes have shifted over the years.

■ The Current System

In the early 1990s, Americans were evenly split in their beliefs about the likelihood that the Social Security system will be able to pay benefits to respondents when they retire; in 1990 and 1991, 49 percent believed they would receive benefits. However, in 1990, 92 percent of respondents did not believe that the Social Security benefits alone would allow them to meet all of their financial needs during retirement. In recent years, most Americans have become aware of the financing issues facing today's Social Security system. By 1995, 82 percent agreed or strongly agreed with the statement that working Americans are beginning to

lose faith in whether Social Security benefits will be available when they retire (appendix C, chart 1).

Is the current Social Security system a good program for today's younger workers? Only one-third of respondents in 1995 either agreed or strongly agreed that it is, while nearly one-half (47 percent) disagreed or disagreed strongly.

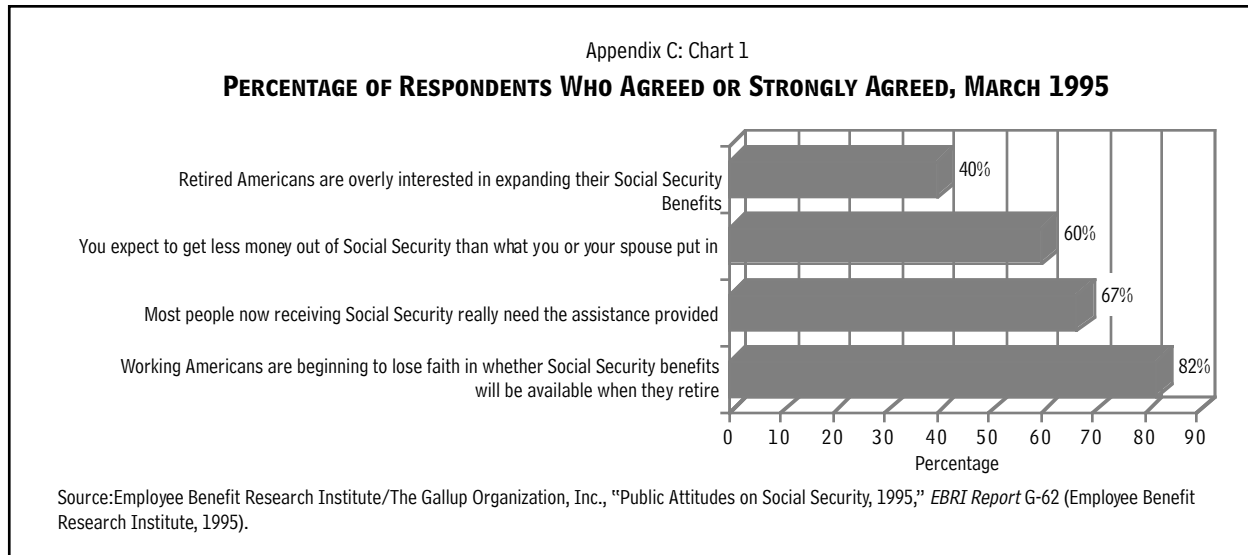
■ Reform Proposals

Several of the reform proposals put forth today advocate contributions to individual retirement accounts. In 1991, when asked if Social Security taxes, or a portion of these taxes, should go to individual retirement accounts in the worker's own name, or if the system should remain as it is, 61 percent thought the money should go to individual accounts, while 32 percent believed the system should stay as it is. The March 1995 survey found that 53 percent agreed or strongly agreed that most people could make more money by investing their retirement funds in the private sector than they could from Social Security. This has been a hot topic recently, with regard to individuals' ability to invest wisely and at an appropriate risk level. These concerns translate into a concern for overall retirement income adequacy.

The idea of a voluntary Social Security system has also arisen in the proposals for reform. In 1990 and 1991, among survey respondents, 45 percent and 50 percent, respectively, were in favor of voluntary participation. While some advocates of reform favor a voluntary program, this idea has raised concern among others regarding the adequacy of individuals' income in retirement.

When respondents were asked in the 1991 survey if they thought higher taxes would be required in order for Social Security benefits to be paid in the next century, 73 percent responded affirmatively. Forty-two percent of individuals

¹ See *Employee Benefit Research Institute/The Gallup Organization, Inc., "Public Attitudes on Social Security, 1990,"* EBRI Report G-7 (Washington, DC: Employee Benefit Research Institute, 1990); *"Public Attitudes on Social Security Benefits, 1991,"* EBRI Report G-23 (Washington, DC: Employee Benefit Research Institute, 1991); *"Public Attitudes on Social Security, Part I,"* EBRI Report G-56 (Washington, DC: Employee Benefit Research Institute, 1993); *"Public Attitudes on Social Security, Part II,"* EBRI Report G-57 (Washington, DC: Employee Benefit Research Institute, 1994); and *"Public Attitudes on Social Security, 1995,"* EBRI Report G-62 (Washington, DC: Employee Benefit Research Institute, 1995).



surveyed in 1995 disagreed or strongly disagreed with the statement that taxes will have to be raised dramatically to pay for Social Security benefits in the future. In comparison, one-third agreed or strongly agreed with the preceding statement.

Contrary to the notion that individuals do not welcome immediate change, in the March 1995 survey, Americans indicated a preference for some immediate tax increases in order to lessen the tax burden on future workers (63 percent in favor) (appendix C, chart 2). Interviewees were informed that, in order to maintain present levels of Social Security benefits for baby boomers, the Social Security payroll tax would have to increase approximately 27 percent to 33 percent for both employers and employees by 2030. Twenty-eight percent said they preferred to postpone taxes until after 2010.

■ Changes in the Level of Benefits Received

Twenty-four percent of surveyed individuals in April 1994 expected the level of Social Security benefits to increase in the future, while 40 percent expected benefits to decrease and 31 percent believed they would be eliminated. Benefits would remain the same, according to 4 percent of respondents. A similar question was asked in March 1995; however, direct comparison of the responses is not possible because the questions were phrased differently² and the response options differed as

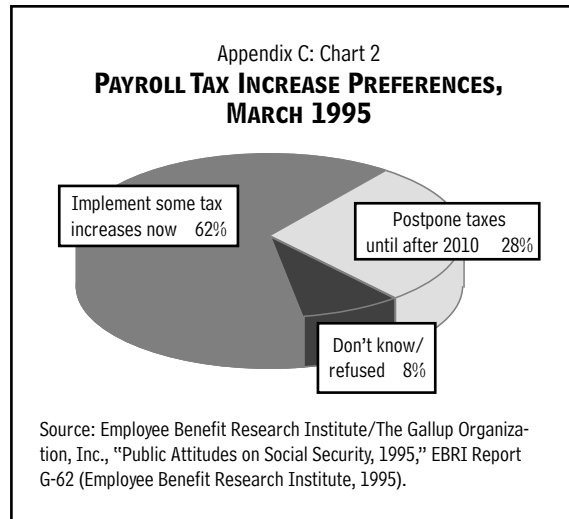
well. In March 1995, 21 percent of respondents expected that benefits would be reduced for all people, whereas 25 percent expected they would be reduced at a greater rate for higher income people than for lower income people. Additionally, 26 percent thought the benefits would stay the same, and one-fifth thought they would be eliminated.

Interestingly, when individuals were asked what they believed *should* happen to the level of benefits (as opposed to what they *expect* to happen), their responses were quite different. Not surprisingly, a greater percentage would prefer to see only some people affected by reform. Five percent believed that Social Security benefits should be reduced for everyone, but 45 percent believed that benefits should be reduced more for higher income people than for lower income people. Another 40 percent thought benefits should stay the same, and 4 percent thought the benefits should be eliminated.

■ Expected Returns

In the March 1995 survey, 60 percent of respon-

² The April 1994 question read, "Do you expect the level of Social Security benefits to increase, decrease, or be eliminated in the future?" while the March 1995 question read, "In the future, do you expect that Social Security benefits will: (a) be reduced for all people, (b) be reduced at a greater rate for high income people than for low income people, (c) stay the same, (d) be eliminated, or (e) don't know."



dents supported the fact that a part of every working person's income goes to support the Social Security program, which is the basic premise of a social insurance program. However, 17 percent of individuals were opposed to this fact. Although a majority believe that everyone should pay into Social Security, some believe that not everyone should receive benefits from the program. Thirty-two percent agreed or strongly agreed that retirees with earnings over \$100,000 should not get Social Security, even if they paid into the system. However, nearly one-half (47 percent) either disagreed or strongly disagreed with the previous statement.

Sixty percent of those surveyed in 1995

expected to receive less money from Social Security than they contributed. Interestingly, age differences existed for this question. Among those aged 18–34 and 35–54, 72 percent and 67 percent, respectively, expected to contribute more money than they would receive from Social Security. In comparison, 34 percent of those aged 55 and over expected to receive less money than they contributed.

In general, Social Security is believed to be a good program and, in 1995, 67 percent agreed or strongly agreed that most people receiving Social Security really need the assistance provided. Most people are now aware of the upcoming issues facing the program and are conscious of the need for some type of reform.

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Center for Policy Research
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The Brookings Institution
<http://www.brook.edu>

The Cato Institute
<http://www.cato.org>

Citizens for a Sound Economy
<http://www.cse.org/cse/welcome.html>

Committee for Economic Development (CED)
<http://ced.sohonet.com>

Common Sense for America (CSFA)
<http://www.csfa.org>

The Democratic Leadership Council & Progressive
Policy Institute
<http://www.dlcppi.org>

The Electronic Policy Network
<http://www.epn.org>

Employee Benefit Research Institute
<http://www.ebri.org>

Institute for Economic Analysis
<http://cpcug.org/user/jatlee>

IntellectualCapital.Com
<http://www.intellectualcapital.com>

The Maxwell School Center for Policy Research
(CPR)
<http://www-cpr.maxwell.syr.edu>

National Academy of Social Insurance
<http://www.idsonline.com/nasi>

National Association of Manufacturers
<http://www.nam.org>

National Bureau of Economic Research, Inc.
<http://www.nber.org>

National Commission on Retirement Policy
<http://www.csis.org/retire/>

Pension Research Council
<http://rider.wharton.upenn.edu/~mitchelo/prc.html>

Policy.com
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The Progress & Freedom Foundation
<http://www.pff.org/pff/>

RAND
<http://www.rand.org>

Social Security Administration
<http://www.ssa.gov>

The Social Security Crisis
<http://www.panix.com/~stern/ss/socindex.html>

The Social Security Reform Research Page
<http://www.execpc.com/~freitag/reform.htm>

The Tax Foundation
<http://www.taxfoundation.org/index.html>

The Urban Institute
<http://www.urban.org>

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