

Social Security—Its Problems and How to Solve Them

Currently social security is running a cash surplus. The surplus will grow smaller when the baby boomers begin to retire, and it will turn into a cash deficit by 2017. Soon afterwards, social security's trust fund will begin cashing in the government iou's that it holds, to pay promised benefits. By 2041 these iou's will be exhausted. If nothing else is done, at that point social security will have enough revenue to pay only 70% of its promised benefits. Put another way, a payroll tax rate of 18-19% (instead of 12.4%) will be needed from 2041 on, to pay the scheduled benefits from OASDI.

In 2001 President Bush appointed a Commission to recommend how we could best solve social security's looming financial problems. This note summarizes the Commission's report and my own views, as a member of that Commission. The Commission concluded that:

- 1) pre-funding our social security obligations with private competitive control over the funds leads to higher benefits and enhances long term sustainability;
- 2) a system of personal retirement accounts (PRAs) as part of social security can be constructed to run with low administrative costs and moderate risk; and
- 3) a key choice we face is whether to maintain scheduled contributions (with a lower wage-replacement rate) or maintain the scheduled replacement rate (with higher revenue needs). Using PRAs improves the terms of this trade-off, but does not completely eliminate it.

Pre-funding with decentralized management of the funds

Opinions are very polarized on how to solve social security's financial problems. But all sides agree on certain points: 1) It is important to modify the system to restore fiscal solvency—the status quo is not an option. 2) It is crucial to have a positive impact on the real economy, by increasing saving and work, which will eventually mean a larger pie for workers and retirees to consume; and 3) Pre-funding is part of the solution.

Pre-funding simply means you plan, save and invest, when you see a large expenditure coming up in the future. Saving and investment for social security avoids the need for a sharp tax hike to pay future benefits. The returns on investments allow a relatively small contribution in the present, when saved, to yield a large future pension. Moreover, pre-funding can be used to increase national saving and productivity, leaving both the social security system and the economy in better shape as a stock of capital assets builds up. For these reasons, every credible plan to “fix” social security involves some pre-funding, either explicitly or implicitly.

Once we have funds, someone has to manage them. And herein lie the biggest controversy and major rationale for personal retirement accounts (PRAs). Most basically, the funds can be placed under public or private management. The choice between these two options determines whether we continue to rely solely on the traditional defined benefit (DB) system, financed in part by public investment, or whether we shift part of the contribution to PRAs, over which individuals have more control. This is a key question that we should be debating.

Many analysts (myself included) believe that private competitive management is strongly preferable. We base this view on the experience of other countries, historical experience in the US, and knowledge of the political culture in the US.

Data on public management of pension reserves in numerous other countries show: 1) Surpluses are spent quickly so the savings don't remain, to pay later pensions. 2) The reserves earn low rates of return that are often below the rate of inflation, which is one reason the savings disappear. 3) Capital is allocated inefficiently. It may be invested in politically motivated projects, where the marginal productivity of capital is low. Often it is invested heavily in government bonds, and increases the national debt. This is bad for the system and bad for the broader economy. In contrast, privately managed pension funds have earned much higher returns because they are invested in diversified portfolios of stocks and bonds, seeking the highest rate of return consistent with moderate risk.

This evidence from other countries is buttressed by historical evidence from the US. Since 1983 the social security trust fund has run an increasing surplus. We must ask ourselves whether that surplus was saved and productively invested, or whether it was simply transferred to the treasury as part of the unified budget, enabling higher spending without higher taxes, and thereby building a larger hidden debt. In fact, the entire surplus in the trust fund has been lent to the government in exchange for special iou's. These iou's can't be traded in the ordinary bond market and they don't appear as part of the national debt. Yet they total more than the explicit national debt and starting shortly after 2017 taxpayers will have to pay the iou's off (after previously paying to create them).

To avoid stimulating deficit spending in this way, some groups have advocated that the government invest the trust fund in the stock market. In my view, this would simply open a Pandora's box in which political pressures rather than economic objectives would determine the allocation of capital and depress its rate of return. The results would be bad for the social security system, the economy and our system of government. These dangers stemming from public management of pension

funds led the President's Commission toward private decentralized competitive management of the social security funds in a system of personal retirement accounts (PRAs). Insert Box 1 here

Designing a PRA system

Three options for introducing PRAs. The Commission proposed 3 options for introducing PRAs and restoring solvency to social security. All options:

- Exclude workers over 55 and make participation voluntary for workers under 55;
- Allow workers to divert (or “carve-out”) part of their payroll tax to the PRA;
- Require workers to repay this “loan” by reducing their DB upon retirement;
- Entail transition finance to meet the system's cash needs before the loan is repaid;
- Increase progressivity while keeping administrative costs and risk low;
- End up with benefits from two sources—the DB + the PRA. Both sources become part of the new social security system.

Model 1 starts the PRA by allowing workers to withdraw 2 percentage points of the payroll tax and place them in an investment account instead. This model does not attempt to solve the fiscal problems of the remaining DB—so it is not a real fix. The Commission was strongly committed to making social security sustainable in the long run. Therefore I will devote my space to the other two options, which accomplish this goal.

Models 2 and 3 make the traditional system sustainable by cutting the defined benefits that workers can expect to receive in the future. Workers are then given the right to take part of their payroll tax and put it into a PRA. The annuity from the PRA restores most or all of the benefit lost through the declining DB. The returns to invested funds enable workers to end up with higher benefits than they would if the same money were simply left in the traditional PAYG system. This corresponds to the real economic growth that we get as a result of increased saving that is productively invested. Because of the build-up of assets, all three options leave the social security system much stronger in 2075, the end of the valuation period, than it is now. Insert Box 2 here

Do we want to maintain scheduled contributions or scheduled benefits?

Models 2 and 3 give different answers to this question. Model 2 aims to live within the scheduled contribution rate, with 4 percentage points (up to \$1000) diverted to the PRA. This means that the total benefit from the DB+PRA falls below the currently scheduled rate and grows slower than wages. Even with investment returns, current contributions simply don't give us enough money to pay the old pension debt plus benefits that are promised for the future. Model 2 produces a benefit that is greater than would

be affordable if the system remained pay-as-you-go, but not quite as high as scheduled benefits (Figure 1).

Model 3, in contrast, aims to maintain the scheduled benefit rate and replacement rate (average benefit/average wage). This requires additional revenues. Model 3 calls for a new dedicated tax revenues for the DB (equivalent to about .6% of payroll) plus a 1% add-on for the PRA, which would be matched by a 2.5% carve-out (up to \$1000). This produces a monthly benefit that exceeds the currently scheduled benefit throughout the 75-year valuation period (Figure 1). Insert Figure 1 here

I personally prefer option 3, because it roughly maintains the current ratio of pensions to wages (the “wage-replacement rate”), which I believe is important in order to avoid pushing many of our old people to the bottom of the income distribution. The add-on plus new dedicated tax in model 3 should raise national saving, which would be good for the economy. Although the Commission did not specify the source of this new dedicated tax, it might come from broadening the payroll tax base at 86-88% of the total wage bill, half-way between its place in 1983 (90%) and its current place (84%); and stabilizing this ratio would help to stabilize the finances of the system. Model 3 also has low transition costs, because it has a smaller carve-out and a larger interest rate for repaying the “loan” than model 2. Other members of the Commission had other preferences. Ultimately, the Congress and the President, rather than the Commission, should make this choice. But regardless of which they choose, PRAs make the trade-off easier—they allow us to get higher benefits at lower cost than we would if we stuck to a strictly pay-as-you-go system.

How to keep administrative costs and risk low, equity high?

Administrative costs.

Critics of PRAs have argued that its administrative costs will be high, especially in the early years when average account size is small. Collection, record-keeping and communications costs tend to be a fixed dollar amount per account, so they will take a large bite out of the returns to small accounts. Also, marketing costs are high in retail financial markets. The Commission spent considerable effort in designing a system to avoid these problems. Specifically, it proposed that PRAs should:

- Piggy-back on the current social security tax collection system;
- Use the wholesale, not the retail market—by aggregating funds and using a competitive bidding process to choose a small group of asset managers (this will allow us to benefit from scale economies and low sales cost);
- Restrict investment to low cost products such as index funds;

- Keep service levels modest to contain record-keeping and communication costs.

The projected annual cost of this system is only .3% of assets, much lower than in other countries or in US mutual funds. Later on, as average account size grows, choice could be opened up to a much broader group of asset managers and portfolios. This would cost a bit more, but would provide better insulation from political control and responsiveness to individual preferences.

Risk. Risk and uncertainty are inevitable in all old age security plans, given the long time horizon (75 years or more) between the date the worker enters the labor force and starts contributing to the date on which he dies and stops collecting benefits. A publicly managed DB scheme involves political risk—it can be changed at the will of Congress—while a privately managed PRA involves financial market risk. The Commission’s approach to risk was to reduce it by diversification. The PRAs are required to be broadly diversified across all sectors of the market. They are diversified between stocks and bonds (the percentage breakdown is up to the individual). They can be diversified between domestic and international securities, to minimize country-specific risk. Money is invested gradually over a long period and is withdrawn gradually over a long period—thereby diversifying across time. Finally, the system as a whole is a mixture of DB+PRA. If your retirement income comes from multiple sources, you are partially protected from the possible failure of any one source.

Equity. Finally, many people worry that a system with PRAs will be less progressive than the current system. To ensure that progressivity would, in fact, increase, the Commission proposals improved benefits for low earners and widows, downsized the DB more at the higher end, and gave low and middle earners greater opportunities to invest in PRAs. New dedicated tax revenues could be set to further increase progressivity.

Conclusion

Many people would like to keep both current benefits and current costs of social security—but this is not a viable option as the system is headed for insolvency. Change is inevitable, and that requires us to face up to some difficult choices:

- Since pre-funding is probable, do we want public or private fund management?
- Do we want to decrease scheduled replacement rates or increase revenues to the system to allow the maintenance of benefits? (PRAs make the required increase in cost or decrease in replacement rates much smaller than otherwise).

- If we establish PRAs, how much individual choice do we allow over investments? Do we restrict choice to contain administrative costs and risk, or give substantial choice to maximize individual freedom and political insulation?
- Other policy choices not deal with in this note: Is a PRA system best set up on a voluntary or mandatory basis? If new revenues are needed, from where do they come? If scheduled benefits are cut, whose benefits? If financial market risk is involved, who bears it and at what cost? What should be done about the fact that the majority of people retire early, even as longevity is increasing? (How) should payouts be restricted, to make sure that people don't run out of money due to myopia or unexpectedly long lifetimes? How should the transition be financed?

These choices are not easy, but establishing a system of PRAs makes them easier by improving the trade-off. PRAs enable solvency with benefits that approach or exceed currently scheduled levels, without large contribution increases. They offer the possibility of enhanced economic growth by keeping payroll taxes low, improving work incentives and increasing national saving. The Commission showed that, contrary to some critics, a PRA system can be run with low administrative cost, reasonable risk and an equitable distribution of costs and benefits. It also showed that value judgments as well as technical expertise are involved in finding a solution.

Box 1: Opening the Pandora's Box: Government Investment in the Stock Market

Suppose that an enlarged trust fund were invested in the stock market by a public agency, to enhance returns. Which companies and industries would the trust fund invest in, and if investing passively, which indexes would be used? Would investments be prohibited in companies producing tobacco, abortion pills and pollution; would companies using non-union labor be off-limits? One can easily imagine pressure groups and campaign contributions playing a large role in these decisions. A conflict of interest would arise between the government as investor and government as regulator, regarding anti-trust cases, the enforcement of health and safety rules, etc. Will the right arm of the government, the regulator, provide inside information to the left arm, the investor, just before it starts an action against a company that might reduce its stock value? Will investment power become very concentrated? Will the government become the major stockholder in small companies or will small companies be excluded from access to the funds? Will the government as stockholder exert influence over corporate managers who may not be performing well—and will the political party and contributions of the manager matter? It is difficult to imagine that these pressures would not play an important role if the trust fund were invested in the stock market. This would be harmful for the social security system, the broader economy, and our system of government.

Box 2: Benefits and sustainability under models 2 and 3

Model 2 aims to make the system sustainable without increasing revenues.

- 1) It downsizes the DB below scheduled levels. This is accomplished very simply: the DB is frozen at 2009 levels instead of rising for future cohorts with the average wage level. Technically, the starting benefit for each successive cohort would be price-indexed, rather than wage-indexed, as it is now. This alone makes the DB system sustainable.
- 2) Workers are then permitted to divert 4 percentage points (up to \$1000) of their payroll tax into their PRAs. Upon retirement workers repay the system for this “loan” with 2% interest, by further reducing their DB.
- 3) The DB+annuity from the PRA yields more than is currently affordable but less than is currently scheduled.

Model 3 aims to maintain scheduled replacement rates from the DB+PRA

- 1) It downsizes the DB, but not as much as Model 2
 - a. Initial annual benefit upon retirement goes up with average wage but goes down as life expectancy increases (longevity indexation).
 - b. Early retirement is further penalized and late retirement rewarded.
 - c. Benefits are flattened out, with a bigger cut at the top end.
- 2) To make the DB sustainable requires new dedicated tax revenues of .6% of payroll.
- 3) Workers can divert 2.5 percentage points of payroll tax (up to \$1000) to their PRAs, but to do so must add-on 1% of wage (with tax credit). This loan is repaid with 2.5% interest, in the form of a reduced DB, later on.
- 4) New resources (1% add-on for PRA + small new dedicated tax revenues for DB) plus investment earnings raise total benefits from DB+PRA above currently scheduled levels.

Figure 1: Benefits under current system, Model 2 and Model 3

Monthly benefits for middle earners under current system and Commission report



