Social Security Reform:
Marginal or Fundamental Change?

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Joseph F. Quinn
Department of Economics
Boston College
Chestnut Hill, MA 02167
phone: (617) 552-4623
fax: (617) 552-2308
joseph.quinn@bc.edu

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Although officially off the table during the recent Presidential campaign, Social Security finances are very much in the news these days. Any discussion of Federal budget balance raises the topic, because Social Security expenditures are the largest item in the Federal budget. This paper discusses the size and timing of the Social Security funding problem, and asks whether there is a Social Security crisis and whether Social Security can be rescued without radical reform. The options proposed by the President's Social Security Advisory Board are then reviewed, followed by a discussion of some pros and cons of partial privatization, the most controversial component of the reform plans.

Demographic change

The age distribution in the U. S. is changing in dramatic fashion. This demographic shift is the primary cause of the funding imbalance of the Old Age, Survivors and Disability Insurance (OASDI) programs -- Social Security.[1] As seen in figure 1, the distribution of the population by age is changing from a rough triangular shape to a much more rectangular configuration by the year 2030, when the last of the baby-boomers will be about to turn 65. Over these next 35 years, while the overall U.S. population increases by about 30 percent, the proportion of Americans aged 55 or over will rise about 90 percent (increasing from 21 to 30 percent of the population), while the proportions aged 65 or over and 85 or over will increase by 105 and 125 percent, respectively. As a result, the median age will rise from 35 to 39, about one year per decade.[2] And perhaps most important from a Social Security funding perspective, the ratio of Social Security contributors to beneficiaries, already down from 5:1 in 1960 to 3.3 to 1 today, will decline further to only 2 to 1 in 2030, and slightly lower thereafter.[3]

The decline in this ratio is a very important change for a program like Social Security, which has traditionally been a pay-as-you-go system, paying current benefits primarily from current OASDI contributions. Instead of each dollar of benefits costing the average contributor 20 cents, as it would have in 1960, it currently costs 33 cents, and will rise to 50 cents as the last baby-boomers reach age 65. In essence, Social Security has worked somewhat like a very successful, mandatory chain letter. Chain letters work better on triangles than on rectangles, which is where the age structure is heading. Although the chain letter is not coming to an end, as real chain letters eventually do, the ratio of contributors to beneficiaries is falling. That, in a nutshell, is the source of the Social Security funding problem.

Compounding this demographic problem is the fact that real wage growth, another engine of the system, has declined. Back in the 1950s and early 1960s, real wages in OASDI covered employment, adjusted for inflation, grew at more than 2 percent per year, significantly increasing Social Security's taxable earnings base. During the past two decades, in stark contrast, real wages increased at only 0.2 percent (1975-1984) and 0.6 percent per year (1985-94).[4] And in the future, they are forecast by the Social Security Trustees to grow at only 1 percent per year -- much lower than long run historical standards, but rather optimistic compared to recent experience.

The bottom line is that the future does not look like the past. The triangle upon Social Security has been based up to now is disappearing. Social Security's primary engine of growth, the expanding wage base, is slowing down, both because of the aging of the baby-boomers and the decline in the growth of real wages.

Is there a Social Security crisis?

Because of these demographic and economic changes, current Social Security tax and benefit rules are inconsistent with each other. Currently anticipated Social Security revenues (primarily from the payroll tax) are inadequate to pay for benefits currently promised. There <u>is</u> a large unfunded long-term liability. How large is it, and when do the problems occur? To

Social Security, long-term refers to the next 75 years -- about a lifetime. Over the next 75 year, the anticipated shortfall (the difference between the present discounted value of revenues and expenditures) averages 2.19 percent of covered payroll, according to the Trustees' intermediate forecasts.[5] In other words, an increase of 1.1 percentage points in the tax rate paid on covered earnings by employers and employees (from 6.2 to 7.3 percent for each) would eliminate this deficit. This would be a significant increase in the rate -- about 18 percent. Alternatively, a similar percentage cut in benefits for all current and future recipients would balance the system through 2070. Either of these would be significant changes, but changes of a size that have been legislated before.

Many analysts claim that this 2.19 percent annual deficit is a deceptive statistic. Some say it exaggerates the size of the Social Security funding problem. Why?? The first reason is that the CPI index probably overstates increases in the cost of living, primarily because of difficulties in measuring quality change. Although there is some consensus among economists that this is the case, there is considerable disagreement over the magnitude of the error. The Bureau of Labor Statistics acknowledges that the mismeasurement might be about one-fifth of a percentage point per year, while the recent Boskin Committee estimated that the error exceeds one point per year. More accurate measures would reduce Social Security benefit increases and thereby lower the long range deficit. The impact of these changes on the unfunded liability is dramatic -- a one percentage point decline in future cost of living adjustments eliminates nearly two-thirds of the 75 year deficit because of slower growth in future Social Security benefits.[6]

The second reason that the 2.19 estimate may be an exaggeration is that it is based on intermediate forecasts of the Social Security Trustees. Under their more optimistic projections -- a lower long run unemployment rate (5 percent instead of 6 percent), a higher future real growth rate for economy (2.2 percent instead of 1.3 percent), higher fertility rates, more immigration, and higher mortality rates (this is the optimistic scenario!) -- reserves bottom out at four times annual Social Security expenditures.[7] If just some of these more optimistic assumptions are true, the Trust Funds may never reach zero.

But others say that the intermediate deficit forecast understates the problem. Why?? Some argue that OASDI should be viewed in the broader context of entitlements, especially Medicare. Medicare's funding problems are larger than those of Social Security and come much sooner, in a matter of years, not decades.[8] What looks like a manageable solution to the Social Security deficit may not appear so when added to whatever must be done to stabilize Medicare finances.

The second argument is that the 75 year deficit averages substantial surpluses now (about $65 billion per year) with large and increasing deficits then (about 5.5 percent of payroll in 2070.) Each year the "75 year" picture gets worse, since a surplus year up front is replaced by a large deficit year at the end. A 2.2 percentage point increase in the payroll tax would not put Social Security into true long term balance. It would just balance <u>this year's</u> 75-year window. A year later, it would out of balance again. This is part of what happened between 1983 (when Social Security was supposed to be fixed for 75 years) and today -- the window moved by 13 years.[9]

On the other hand, the year 2070 is a long time from now. Even an economist, usually eager to predict anything, anytime, anywhere, would have been hard-pressed in 1921 (75 years ago) to predict what has happened since then. In considering these forecasts, it is wise to remember the economists' motto: "raro cum verita; numquam in dubito" --"rarely right, but never in doubt."

With the current Social Security tax and benefit rules, when do the financial difficulties occur? In 2013, 16 years from now, Social Security benefits would first exceed Social Security payroll taxes, the primary source of revenue. But there are two other revenue sources, interest on the Trust Fund reserves and Federal income taxes on the Social Security benefits of high income recipients, some of which goes to the OASDI Trust Funds and the rest of which goes to Medicare. In 2019, 6 years later and 22 years from now, Social Security expenditures would exceed all sources of revenues, and the Trust Funds would peak and begin to decline. In 2029, 32 years from now, the Trust Funds would finally be depleted, annual obligations would exceed annual receipts, and Social Security would be technically bankrupt. Even in this unfortunate scenario, however, Social Security revenues would be sufficient to meet three-quarters of obligations through 2070.[10] Social Security would still "be there," just not at the levels currently promised.

Is there a crisis here? From a broader entitlements perspective, the term "crisis" may be justified. But the crisis component is Medicare, not retirement. The Medicare problems arrive much sooner than the retirement problems, long before baby-boomers arrive on the scene. The Medicare Trust funds will be depleted in 2001. The Medicare deficits are projected to grow much faster, and the arrival of baby boomers at the Medicare eligibility threshold will only accentuate the problem. Finally, the Medicare problems are much tougher to deal with, since they are part of a much bigger and more intractable issue -- the provision of medical care in America.

But there is good news here too. The good news is that Medicare is not our topic. Our topic is Social Security, and from a Social Security retirement perspective, there is no crisis. There is a problem, if the intermediate forecasts are accurate, but a manageable one. In fact, the Social Security Advisory Council has presented three very different proposals that do manage it, and eliminate the 75 year deficit. The Social Security deficit is a problem that deserves attention, and a problem that could turn into a crisis with sufficient inattention.

Social Security reform is inevitable. Some combination of revenue increases and benefit decreases or delays is needed, and some combination will occur. It is not a matter of "if", but rather of "when" and "how." There is little disagreement on these three basic facts: that important demographic changes are underway, that there is a long run fiscal imbalance in Social Security, and therefore that reform is inevitable. There is some disagreement on when reform should occur (some analysts say why worry about a problem that is 32 years away), and, as we will see, there is substantial disagreement on how Social Security should be reformed.

The Advisory Council's reform options

Every four years, the President appoints an Advisory Council to investigate some aspect of Social Security. The marching orders for the recent Council were to analyze the long-range financing of the non-Medicare components of Social Security, and to propose recommendations for change. Although the Council members agreed on the magnitude and timing of the problem, they disagreed on the appropriate solution. Rather then present a single consensus position, the 13 members outlined three very different visions of the future, all of which deal with the 75 year deficit.[11] One stays well within the current parameters of Social Security, and does what has often been done before -- it raises revenues to finance the benefits that have been promised. The second proposal also maintains the basic structure of Social Security, relies more on benefit cuts than revenue increases to eliminate the deficit, and then adds a new and controversial element to the mix. The third adds this new and controversial element and changes the basic structure of Social Security.[12] The proposals can be described as traditional, traditional with a twist, and nontraditional.

All three plans propose utilizing private capital markets for the first time. Two of the three introduce mandatory individual retirement accounts for all workers, a new concept for Social Security. And one would change the nature of the program in fundamental ways, changes that are either exciting and visionary or deeply troubling depending on one's political philosophy, one's evaluation criteria, and one's view of the future under this third plan.

The traditional approach is represented by the Maintenance of Benefits (MB) plan, which is supported by six members of the Council, including Robert Ball, the Commissioner of Social Security under Presidents Kennedy, Johnson and Nixon. This plan proposes no major benefit cuts, but maintains the delay in the normal retirement age (NRA) from 65 to 67 which was legislated in 1983 and which is about to go into effect. This delay in the NRA is equivalent to a significant benefit cut, on the order of 15 percent on average, even though it is not usually described as one. This plan also includes an increase in the earnings averaging period from the best 35 to the best 38 years of each individual's earnings. Since this adds three years of lower earnings to the calculations on which benefits are based, it is equivalent to a small benefit cut, about 3 percent across the board, even though it is not described as one. Other than that, this plan pays for currently promised benefits by raising Social Security revenues.

The MB plan proposes the additional federal income taxation of Social Security benefits. All benefits in excess of the employees' own contributions, which have already been taxed, would become taxable income, and, beginning in 2010, all the income tax proceeds on Social Security benefits would be directed to the OASDI Trust Funds, rather than be split with the Hospital Insurance (HI) component of Medicare. This plan would also mandate the inclusion of all new state and local employees in Social Security, which would raise future benefit obligations but by less than the increase in revenues. In addition, the plan proposes a 1.6 percentage point increase in the combined employer-employee payroll tax, but not until 2045. And finally, the MB plan proposes the allocation of up to 40 percent of Trust Funds in common stocks. The goal here is to increase the rate of return on Trust Fund reserves. With the latter exception, this is the traditional approach, to raise revenues to meet the obligations under current law.

The traditional with a twist proposal is the Individual Accounts (IA) plan, supported by two members of the Council, including Edward Gramlich, the Chair. It combines small revenue increases with more significant benefit decreases to close the Social Security funding gap. Unlike the MB plan, there is no increase in the payroll tax rate to shore up Trust Fund reserves. There is the same additional taxation of Social Security benefits, but without the redirection of the HI funds, the same inclusion of new state and local employees, and the same increase in the earnings averaging period from 35 to 38 years. In addition, this plan would increase the normal retirement age to age 67 more quickly (by 2011), after which it would be indexed to changes in longevity, estimated to add about one month every two years. This additional benefit delay is equivalent to a further across-the-board benefit cut, although it is not usually called one. Finally, the IA plan scales back the benefits of future middle- and upper-income recipients by about 20 percent by altering the benefit calculation formula. This is a straightforward benefit cut, and, finally, it is called one.

The twist in this plan is an additional payroll contribution of 1.6 percent (up to the taxable limit) that goes not to the Trust Funds, but rather into a new mandatory savings vehicle, an Individual (retirement) Account. This is designed to offset, on average, the proposed benefit cuts. Unlike the current payroll tax, these incremental contributions would not be part of the government budget, and therefore would not be included in the federal deficit calculations. These assets would be administered by the Social Security Administration, with allocation decisions made by the individuals from among a small number of stock and bond index funds. Unlike the current Social Security system, there would exist a real account for each contributor, with a balance reflecting that individual's investment decisions. This is a radically new concept for Social Security. At or after age 62, the proceeds would be available as an annuity provided by the Government.

The non-traditional plan is Personal Security Account (PSA) plan, which is supported by five members of the Council, including Sylvester Schieber and Carolyn Weaver, a member of the new permanent Social Security Advisory Board. This proposal includes the federal income taxation of Social Security benefits, the increase in the computational period (for those over the age of 25 in 1998, whose benefits would partially reflect the current system), the inclusion of sate and local employees and the faster increase (to age 67 by 2011) and subsequent automatic indexation of the normal retirement age.

In addition, the PSA plan envisions a radical transformation of Social Security. It would continue survivors and dependents programs (which utilize about 2.4 of the 12.4 percent payroll tax), and divides the remaining 10 percent in half to create an explicit two-tier system. Half of the 10 percent would be used to support the lower tier, a flat-rate benefit for all those fully insured. This is a defined benefit, like the current Social Security benefit, but independent of earnings. The amount proposed is $410 per month (in 1996 dollars), about 80 percent of the special minimum Social Security retirement benefit paid today, about 2/3 of the poverty level for an elderly person living alone, and 57 percent of the average retiree benefit.[13] As the normal retirement age rises, the age of eligibility for these tier I benefits would increase as well, reaching 65 by the year 2035.

The other half of the 10 percent would be diverted to a mandatory "IRA" for all workers. As in the IA plan, these funds would not be part of the government budget and not part of federal deficit calculation. The funds would be controlled by the individual, outside of Social Security, within some federal regulatory structure. This is a defined contribution plan, whose eventual value depends on the performance of each individual's investments. At or after age 62, the proceeds could be taken out in lump-sum or used to purchase an annuity.

Despite the decline in future defined benefits, additional funds would be required to finance the remaining unfunded liability. The PSA plan envisions transitional borrowing by the Federal government, to be repaid with the proceeds of an additional payroll tax of 1.52 percent of covered earnings over the next 72 years.

There are two very significant changes proposed in this third plan. The first is the clear separation of the social adequacy/income redistribution component of Social Security from the individual equity/savings component. Both are now integrated in one complicated benefit formula. The second is the creation of an account that belongs to the individual. This is the partial privatization of Social Security, and two of the three Council proposals include it. The IA plan has a small version, 1.6 percent of covered payroll, <u>in addition to</u> current 12.4 percent payroll tax. The PSA plan has a big version, 5 percent of payroll, <u>diverted from</u> the current 12.4 percent.

Evaluation criteria

How does one evaluate these proposals? What criteria are appropriate? The criteria depend on the goals of the program. Social Security is a complex institution that plays many roles in America. It has a <u>savings</u> aspect, because reallocates income over time, from working years to retirement years. It is also an <u>insurance</u> program, which replaces some of the income lost following the disability or death of a wage earner. Finally and most fundamentally, Social Security is a huge income maintenance and income redistribution program, whose progressive benefit structure transfers income from high lifetime to low lifetime earners.

These multiple roles create multiple goals for Social Security. The insurance and income redistribution roles suggest income adequacy. Are benefit levels sufficient for recipients to maintain some minimum standard of living? Savings accounts and IRAs are not concerned with that, and do not vary their rates of return with the level of lifetime earnings as Social Security does. The savings aspect, on the other hand, suggests individual equity as a criterion. What is the relationship between what an individual contributes to the system and what that individual gets out? What is the rate of return on an individual's contributions? Is Social Security a good investment?

Before returning to the Social Security Advisory Council proposals, let us ask how Social Security has done in the past with respect to the income adequacy and return on investment criteria. This will provide some insight on the criticisms leveled at Social Security today.

Because of the age distribution of the population (the triangle) and the growth in real wages, Social Security has been able to do very well on both goals -- up to now. But this will not be the case in the future, and this is the source of much of the current discontent.

Social Security has profoundly improved the economic well-being of low- and middle-income older Americans. In 1967, only 30 years ago, 30 percent of all Americans aged 65 or older were poor, and this was twice the overall poverty rate. Real Social Security benefits were increased substantially during the late 1960s and early 1970s, and poverty among the elderly plummeted. In only seven years, the elderly poverty rate fell by half. Since 1982, it has been below the overall rate. This dramatic change occurred while people were retiring earlier and earlier, which makes the progress all the more impressive.

A similar picture emerges when one examines the individual equity goal of Social Security. Because of the favorable demographics, past and current cohorts of retirees received several times what their (and their employers') contributions would have produced had they been invested in similarly safe investments, such as government bonds. The return varies with income level (since the progressive benefit structure favors low-wage earners), gender (since women live longer than men) and age cohort (the earlier cohorts did the best).[14]

But this will not be the case for future cohorts of retirees, because of the change in demographics. Rates of return are dropping over time. To many younger workers, Social Security no longer looks like a "good investment." Many types of workers can expect to receive less in Social Security retirement benefits than their payroll contributions would have earned in alternative low-risk investments.

Figure 2 shows the net transfer expected from Social Security, as a percentage of lifetime income. The zero baseline denotes a two percent real rate of return (the rate of return assumed for an alternative low-risk investment), positive numbers represent a return in excess of that, and negative numbers a smaller return, and therefore a net transfer from the individual to Social Security. Individuals are categorized by demographic status (single males, and one- and two-earner couples), and by wage level (low, average and high).

There are two key points here. The graphs of expected returns are falling over time, and many are heading below the break-even baseline. The first to go under are single males, who expect no spousal or survivors' benefits. (Single females, not shown, lag a bit because of their longer life expectancy.) Next are two-earner couples with high wages, who have lower rates of return to begin with because of the progressive benefit structure, and expect little or no spousal benefit since spouses in the future are likely to earn benefits on their own. Single-earner couples continue to do well, because of the subsidy inherent in the spousal benefit.

The absolute size of these opportunity costs can be large. For a high-wage single male retiring at age 65 in 2005, and therefore aged 57 today, the difference between the discounted value of the expected benefit stream and the present value of prior contributions invested at a 2 percent real rate of return is more than $70,000 (in 1993 dollars.) For high-wage single workers or two-earner couples born in 1965, and therefore aged 32 today, the differentials are in the $160,000 to $225,000 range.[15]

Here is the source of privatization's appeal. Proponents are looking for a new engine for Social Security, to provide the growth that demographics and strong real wage growth provided in the past. The mechanism they have found is the equity market.

Thoughts on Privatization

The term privatization has been used for two very different ideas. The first is found in the Maintenance of Benefits plan outlined above -- that some of the Social Security Trust Fund reserves should be invested in common stocks, rather than entirely in Treasury bonds as they are required to be now. In this case, the structure of Social Security would remain the same; only its Trust Fund portfolio would change.

From Social Security's perspective, on purely economic grounds, this is sensible. Portfolios usually should be diversified. Historically, bonds have provided lower returns than have equities. Although this asset shift by itself would not increase future output, the higher expected rate of return on stocks could increase Social Security's claim on future output.

There are risks, of course, to adding equities to the Social Security portfolio, both short run fluctuations (which Social Security should be able to weather without difficulty), and the possibility of long run stagnation.[16] Even if the latter is unlikely, it is worth considering who bears this risk in this eventuality -- future recipients, through lower benefits, future workers, through higher payroll taxes, or future taxpayers in general, were Social Security to be bailed out from general revenues?

There is opposition to this type of privatization on political grounds. Critics question the wisdom of having the federal government, through the Social Security Administration, controlling significant equity holdings. Although proponents envision that Social Security would invest passively in broad market indexes, others question whether Congress would be able to avoid micro managing -- steering the portfolio toward politically preferred assets (the equities of socially responsible firms? firms that train their workers?) and away from assets deemed inappropriate (tobacco or liquor company stocks? firms that trade with undesirable regimes?).

The other type of privatization, and the real focus of attention here, is the mandatory individual retirement account included in two of the three Advisory Council plans. Individual contributors would have at least some management discretion over their funds, and the eventual benefits received would depend on investment performance, not on decisions of Congress. This would represent a major change in philosophy for Social Security.

There are many important details of these proposals that would have to be determined by Congress. How much investment discretion would individuals actually have? What would be the regulatory environment in which these individual decisions are made? Could people access these funds before retirement, and if so, under what conditions? Could a person with educational needs or a serious medical emergency or an unemployed individual about to lose a home utilize these funds? Proponents say no, but some wonder whether exceptions might soon be made. Would these funds count as assets for means-tested transfer programs? At retirement, could these assets be withdrawn in a lump-sum (yes, in the PSA plan; no in the IA plan), or must some or all of the assets or all be annuitized? Who would provide the annuities?

Even without answers to these important questions, we can ask what this kind of partial privatization would do. There are implications in several areas.

Partial privatization of Social Security would change the nature of the risk facing individuals. It would increase the market risk associated with future retirement income, which critics always point out. But it would also lower the political risk, the power of Congress to alter one's retirement income, which happens every time Congress changes the benefit structure. Rather than simply increase or decrease risk, privatization changes the portfolio of risk -- more of one type, less of another.

Privatization gives more personal responsibility to individuals, since they are required to make decisions that affect their own future retirement income. This is consistent with today's increased emphasis on individual rights and responsibilities. In addition, it would induce some to add an important element currently missing in their portfolios -- equities. It may induce some people to do what they might not have done on their own, but what might turn out to be good for them in the long run.

Privatization, and the additional responsibilities it entails, might induce some people to think more about their own plans and (often inadequate) preparations for retirement, and therefore might encourage more private saving in other forms as well. On the other hand, if people felt more confident about the future following privatization, they might feel that could get by with saving less.

Partial privatization would undoubtedly alter the financial well-being of future retirees. It would improve it on average, according to proponents. Projections of the Social Security Advisory Council, for example, show that the Personal Security Account plan provides a higher ratio of expected benefits to expected contributions than either the Individual Account or the Maintenance of Benefits plan for composite workers at four very different earnings levels.[17] These projections assume that equities continue to outperform government bonds by traditional margins, about 4.7 percent, and that IA and PSA assets are allocated among equities and other assets consistent with current 401(k) experience.[18]

Of course, traditional differentials may not hold in the future, and even if they do, what happens on average will not happen to all. Some might lose more in Social Security benefit reductions (the lower-tier, flat rate benefit) than they gain from their new investment opportunities. Others might spend or invest unwisely a lump-sum distribution, and then find themselves worse off than they would have been under the old annuitized system.

Finally, the partial privatization in the third plan explicitly separates two of Social Security's goals, income adequacy (the income redistribution part) and individual equity (the rate of return part). Proponents applaud this, arguing that Social Security is both an income redistribution program and a savings vehicle, so why disguise these very different roles in one opaque benefit formula? Why not be explicit about what we are doing, and, as a society, openly debate the appropriate magnitude of these important roles?

Critics, on the other hand, fear the long-run political consequences of an explicit two-tiered system. They see the creation of one component of Social Security of primary interest to the poor -- the lower tier, flat-rate defined benefit, the redistributional part -- and another component of primary interest to the rich -- the upper tier savings vehicle, the defined contribution part.[19] Critics wonder about the long-run popularity and political support for the flat rate benefit. Would the lower tier develop a welfare aura, and eventually be viewed more like Supplementary Security Income (SSI) than Social Security? Would the relative size of the lower tier shrink over time?

More generally, critics lament the diminished emphasis on the social insurance aspect of Social Security. The program was created not as a saving vehicle, but rather as a way for society to protect its citizens against some of the economic consequences of several common risks -- disability, death, outliving one's assets and inadequate income in old age. From this perspective, Social Security does not represent a personal investment, on which one earns a rate of return, but rather an investment in the common good. Critics of privatization worry that the separation of Social Security into these two components would eventually destroy America's largest and most successful social insurance program, at a time when there already seems to be too little social cohesion and common purpose in our society.

Partial privatization is an intriguing idea, and deserves serious study. It addresses some legitimate money's-worth concerns about Social Security which are difficult to ignore given the size of the payroll tax. It encourages personal responsibility for retirement, and may increase, on average, the economic well-being of future retirees. Yet there are areas of serious concern. Emphasis on the savings and rate of return aspects of Social Security (a relatively new phenomenon) detracts attention from its other very important missions, as a provider of social insurance, as the guaranteed cornerstone of income security for the elderly and as a key component of social solidarity.

Summary

Despite the significant areas of disagreement among the Advisory Council members, illustrated by their three very different visions of Social Security's future, they did reach consensus on a wide range of important issues. The members agreed that

- the nation should continue a mandatory, universal, public insurance program with retirement, survivors and disability components,
- this program should have a progressive benefit structure (i.e., income redistribution through Social Security is appropriate),
- all new state and local government employees should be included in Social Security,
- Social Security benefits should <u>not</u> be means-tested,
- Social Security benefits should <u>not</u> be indexed at less than the cost-of-living, and
- that the normal retirement age should increase from 65 to 67, or higher.

These are basic agreements by people of widely divergent political philosophies. This should be read as an important endorsement of Social Security, although not necessarily of Social Security as we know it.

In the future, as today, the elderly will consume goods and services, not stocks, bonds, or Social Security Trust Funds. The elderly will consume some part of the national output being produced at that time. Social Security Trust Funds are just pieces of paper or electronic entries, not goods and services. They are claims of one branch of government (Social Security) on another (the Treasury), and therefore, claims on a portion of future output. They are claims whose value can change, as it does every time Congress legislates an alteration in the benefit structure.

As important as the proportion of the pie allocated to the elderly is the size of that pie, the size of the real economy of the future. How large a national output will we be producing when the baby-boomers retire? Whatever the answer, society will decide then how to distribute this output, through the tax and transfer policies (including Social Security rules) that they adopt. Nothing we do now, including creating a large Trust Fund, can pre-determine the allocation decisions that society will choose to make then.

Policy today should encourage saving, investment and economic growth, while maintaining income security for the elderly and the disabled. These are the issues that Congress should be addressing. Fundamental reform through partial privatization may or may not be a good idea. It deserves consideration, but it is not necessary to save Social Security. Incremental change, as we have legislated in the past, can do that, as can the intermediate Individual Accounts plan, which adds a modest mandatory saving component to a traditional, though downsized, Social Security system. As a nation, we should be very careful about radically changing a program that has been as successful and important as Social Security has.

This is the last of thirteen Social Security Advisory Councils. The quadrennial Councils have been replaced by a permanent Advisory Board. Some critics contend that this last Council's inability to reach a consensus and propose a single vision for the future has doomed their considerable efforts to irrelevance. This would be a shame. In fact, they have done us a great service, by not coming to a lukewarm consensus where none exists, by clarifying the political and philosophical differences that do exist, and by laying the ground work for an informed national debate.

Although Social Security does not face the short-run funding problems that Medicare does, it would be a mistake to use the three decades between now and the depletion date of the Trust Funds as an excuse for inaction. The longer the delay, the larger the changes that will be required. Whatever the legislative timetable, it will be wise to include an implementation lag into the reform proposals, to allow those who have made savings and retirement plans under one set of expectations the time necessary to adjust to whatever new environment they face.

[1] Social Security also includes Medicare, which is not part of the focus of this paper. Here, Social Security will refer to all the non-Medicare components; that is, Old Age, Survivors and Disability Insurance (OASDI).

[2] These demographic forecasts are taken from the U. S. Bureau of the Census, Population Projections of the United States by Age, Sex, Race and Hispanic Origin: 1995-2050, Current Population Report P25-1130, February 1996, table 2.

[3] 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Washington, D.C., June 1996, figure I.H2.

[4] 1996 Annual Report, op. cit., p. 149.

[5] This estimate is up slightly from the 2.17 annual deficit projected in the 1995 Trustees' Report. Because the 1996 estimate came out during the deliberations of the Advisory Council and because the difference was so small, the Advisory Council projections are all based on a 2.17 percent average annual deficit.

[6] Report of the 1994-1996 Advisory Council on Social Security, Volume 1: Findings and Recommendations, Washington, D.C., January 1997, pp. 170 and 232.

[7] 1996 Annual Report, op. cit., figure I.H3.

[8] For a summary of Social Security finances from a broader entitlements perspective, see Joseph Quinn, Entitlements and the Federal Budget: Security the Future, Washington, D.C.: National Academy on Aging, May 1996.

[9] The 13 year change in the forecast period is responsible for a quarter of the change from 75-year balance in 1983 to a 2.19 percent deficit today. The remainder is due to new legislation and to changes in the economic, demographic and disability assumptions used in the forecasts. See Report of the 1994-1996 Advisory Council on Social Security, Volume 1, op. cit., pp. 163-164.

[10] In 2030, tax revenues would equal 77 percent of expenditures. By 2070, the end of the accounting period, revenues would cover only 71 percent of annual expenditures. See 1996 Annual Report, op. cit., pp. 4-5.

[11] The Council proposals are described in detail in the Report of the 1994-1996 Advisory Council on Social Security, Volume 1, op. cit., pp. 25-33.

[12] An excellent, concise summary of the proposals' features can be found in the National Academy of Social Insurance, Social Insurance Update, Volume 1, No. 3, December 1996. The plans are also discussed and analyzed at length in chapter 3 of the 1997 Economic Report of the President, Washington, D.C., February 1997.

[13] The flat-rate tier I benefit would be wage-indexed until the worker was eligible to retire, and price-indexed thereafter.

The special minimum benefit is designed for workers with many years of covered employment but low earnings. It is based on years of coverage, not on average indexed monthly earnings. The average special minimum benefit was $502 in December 1996 (as yet unpublished Social Security Administration data). See the Annual Statistical Supplement of the Social

Security Bulletin, 1995, table 5.A8 (for the analogous 1994 figure) and page 397, for a full description of this benefit.

In March 1996, the average monthly benefit for retired workers was $721 ($811 for men and $622 for women). See the Social Security Bulletin, Summer 1996, table 1.B3.

[14] Estimates of these rates of return for various types of participants can be found in C. Eugene Steuerle and Jon M. Bakija (1994), Retooling Social Security for the 21st Century, Washington, D.C.: The Urban Institute Press, 1994, chapter 5.

[15] See Steuerle and Bakija, op. cit., table A3.

[16] According to the 1997 Economic Report of the President (p. 113), a broad index of the stock market dropped by more than 10 percent over a calendar year eight times during the past 70 years, and three times dropped over a year or two by more than 35 percent.

[17] Report of the 1994-1996 Advisory Council on Social Security, Volume 1, op. cit., p. 49. The composite workers are weighted averages of single workers, married workers in one-earner families and married workers in two-worker families. Detailed calculations for these types of workers separately can be found in appendix 2 of volume 1 of the Report. Two exceptions to the general rule that the PSA plan does best are married couples with one-earner, who lose the spousal subsidy, and workers disabled well before the age of retirement (e.g., age 50), who are unable to claim their PSA accumulations until retirement age. In both of these cases the MB plan does best.

[18] See Report of the 1994-1996 Advisory Council on Social Security, Volume 1, op. cit., pp. 170-172.

[19] In the steady state, it is projected that about 80 percent of the total tier I plus tier II benefits of workers with a history of maximum covered earnings ($61,000 in 1995 dollars) would come from their Personal Security Accounts; for low-wage workers (averaging $15,000 per year in 1995 dollars), about 40 percent would come from their PSAs, and the remainder from their flat rate benefits. See Report of the 1994-1996 Advisory Council on Social Security, Volume 1, op. cit., page 47.

Figure 1-a (cont.): Projections of the Population, 1996

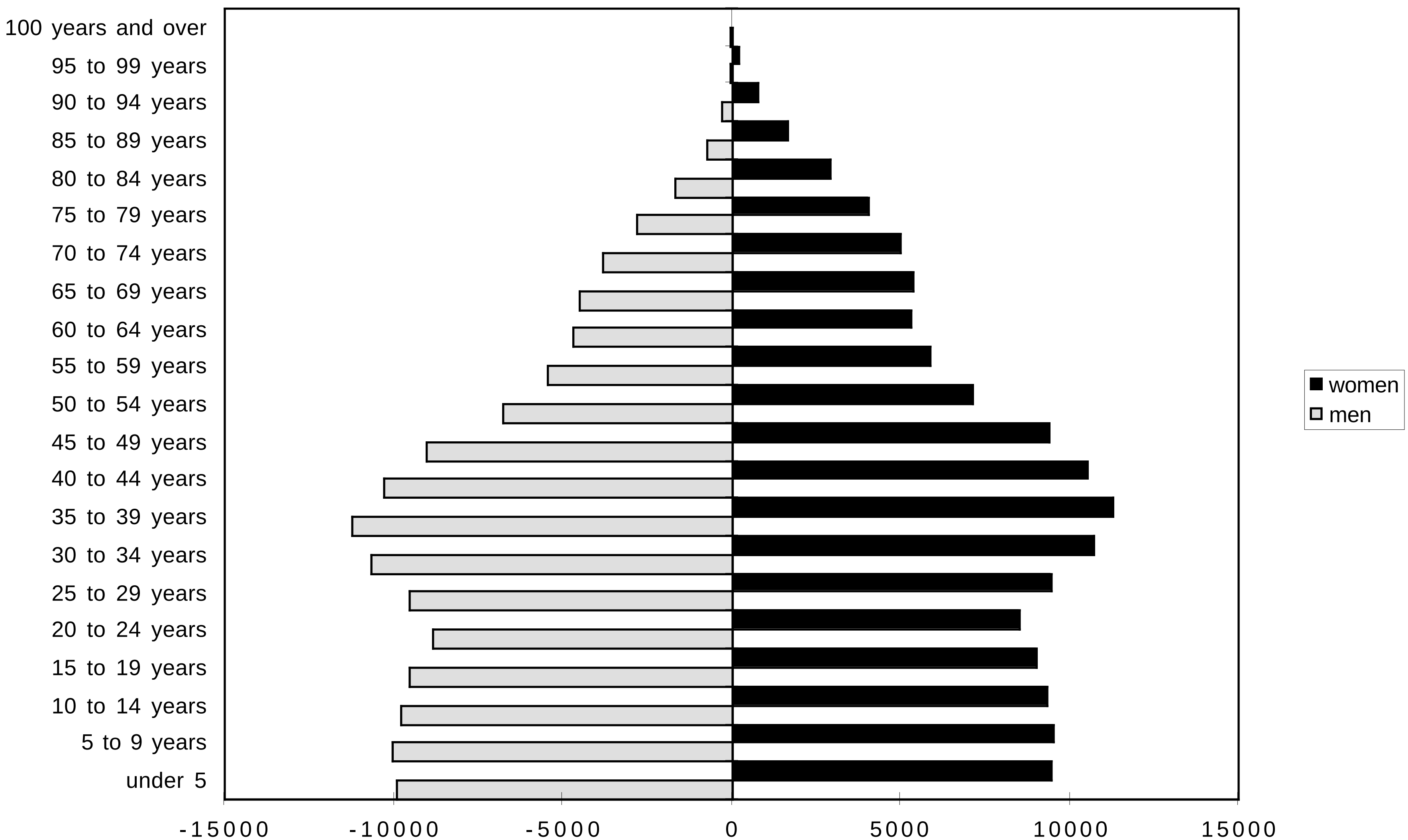


Figure 1-a (cont.): Projections of the Population, 2030

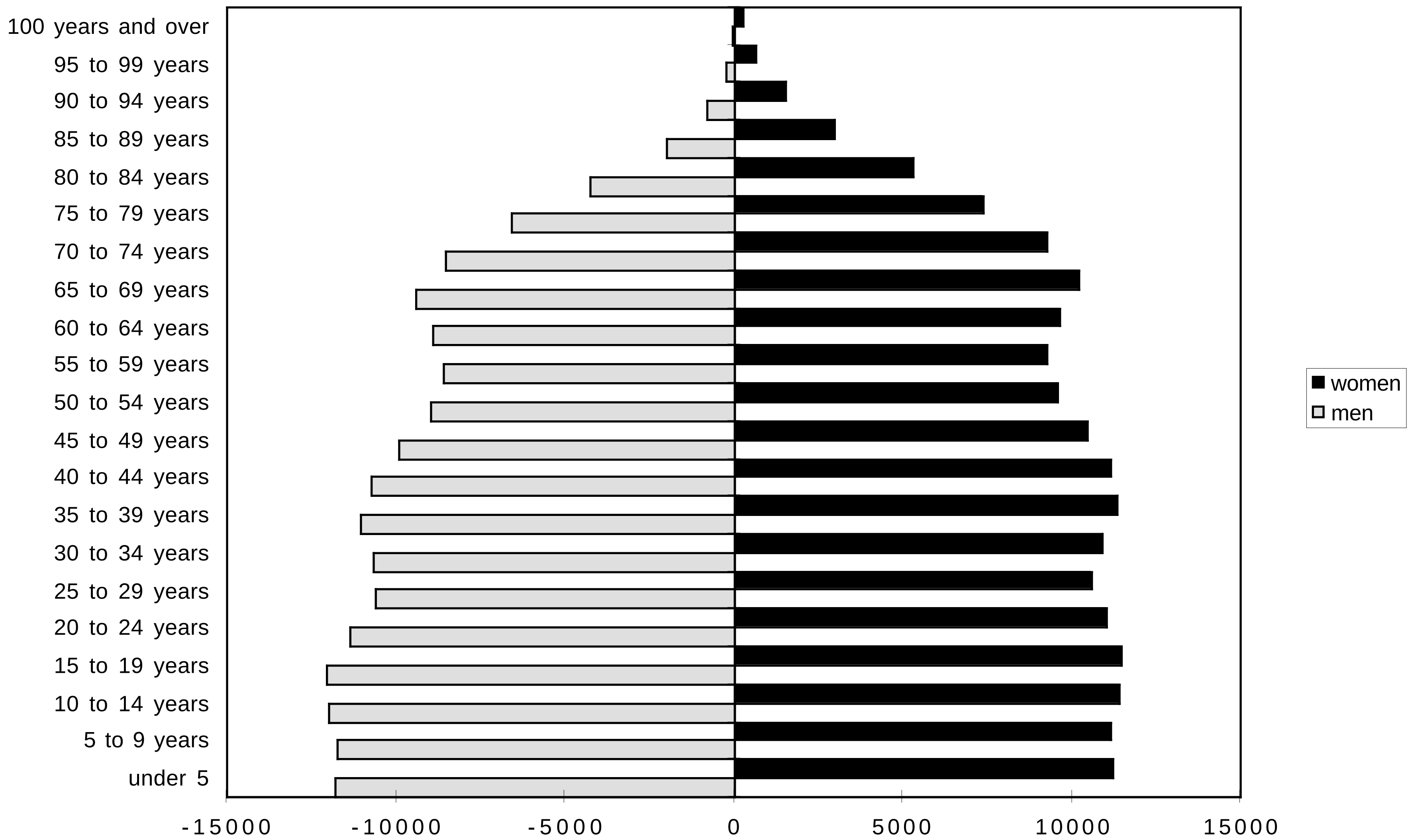
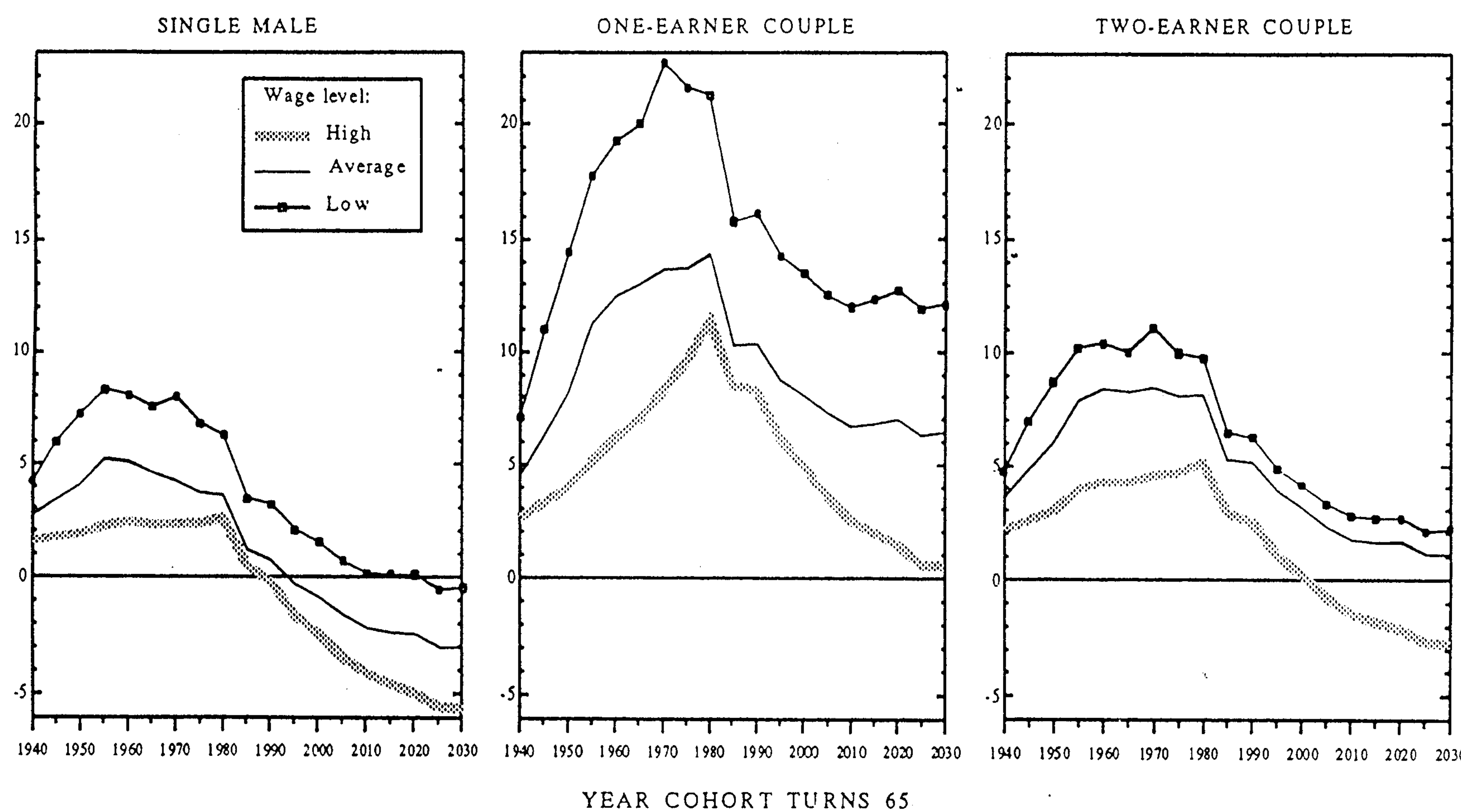


Figure 2

Net OASI Transfer as Percentage of Lifetime Income, Cohorts Turning 65, 1940-2030



Source: Steuerle and Bakija (1994), figure 5.4