New Opportunities for the Social Security System

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Prospects for Social Security Reform

Edited by Olivia S. Mitchell, Robert J. Myers, and Howard Young

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Frontispiece: Special Treasury securities, stored in a federal government filing cabinet in West Virginia, represent $700 billion in Social Security Trust Fund assets. Photo: Jeff Baughan.
The U.S. social security system is in need of reform to close the anticipated gap between income and costs after the baby boom generation begins to retire in 2010. Our goals in this chapter are to discuss the financing problem facing the social security system, and then to raise issues we believe need further analysis in the reform. These issues pertain to approaches for at least partially solving the system's financing problem—investment of a portion of the reserve now accumulating in equities rather than in government bonds, or the creation of funded individual investment accounts. These topics are ones in which we have particular interest as the two public members of the Board of Trustees of the Social Security and Medicare Trust Funds. But as Trustees, our highest interest is in increasing public understanding of the alternatives for reform, so that support for a specific reform plan can build. This process is urgent, because even though there is not an immediate crisis in social security program financing, reforms enacted sooner will spread more broadly the burden of those changes across different age groups.

For an informed public debate about the extent and type of reform that is necessary, many questions need to be addressed. These questions run the gamut from philosophical issues—such as whether in post-industrial economies individual self-reliance is preferable to social insurance—to highly technical issues such as measurement of the cost-of-living index for adjustment of benefit amounts. We will not attempt to list, much less answer, all of these questions, but as the debate about change intensifies it is important, to keep in perspective the breadth of possible reforms of the social security program. The legislative process tends to narrow discussion quickly and focus on specific proposals, but it is axiomatic that changes cannot be made in the social security program unless and until the public accepts those changes.
The Social Security Financing Problem

The Social Security Board of Trustees is required by the Social Security Act to report to the Congress each year on the current and projected future financial status of the social security program. Information is provided separately in the report for the Old-Age and Survivors Insurance (OASI) and the Disability Insurance (DI) programs, since each has its own tax rate, benefit provisions, and trust fund. However, the two trust funds are frequently considered together as OASDI for discussion purposes.

Workers entering the labor force today may be receiving benefits as much as 75 years from now; the 1997 Trustees Report provided social security financing projections that far into the future — until 2071. But it is crucial to recognize the enormity of the task of making such projections. A review of social security financing projections across recent Trustees Reports shows that the future cannot be predicted with certainty, even if the social security law remains unchanged. This is because future income from payroll taxes, interest, and other sources, and future expenditures for benefits, will depend upon a large number of unknowns including the size and characteristics of the work force subject to payroll taxes, the level of workers' earnings, and the size and composition of the population receiving benefits as well as the level of those benefits. These unknowns depend in turn on future rates of birth, marriage, divorce, death, disability, migration, labor force participation, unemployment, productivity gains, wage increases, changes in the cost-of-living (and in its measurement), and many other economic and demographic variables.

The complexity of the social and economic factors involved and the long time horizon used mean that alternative sets of assumptions are required to give a range of possible future outcomes. Currently the Trustees Report provides projections under three sets of economic and demographic assumptions, to show a range of possible future program experience. The intermediate (Alternative II) set of assumptions in the Trustees Report reflects the Trustees' best estimate of future experience. The low-cost, Alternative I, assumptions are more optimistic; while the high-cost, Alternative III, assumptions are more pessimistic. Current discussions about changes in OASDI financing, like the discussions preceding the social security legislative changes in 1977 and particularly in 1983, generally rely on point estimates using the intermediate assumptions and, at least implicitly, treat them as exact. In the future, when considering social security financing changes, we should try to help policymakers and the public keep in mind the purpose of the more optimistic Alternative I and the more pessimistic Alternative III sets of assumptions in the Trustees Report. They help stress the fact that the Trustees' long-range projections provide a range of future possibilities rather than a single point estimate.
When experience deviates from the best estimates, or when estimates of future experience are revised and the long-range financial result worsens (as has happened since the 1983 financing changes), some might conclude that there is a flaw in the social security program. In fact, what has happened since 1983 is that experience generally has provided additional evidence of economic and demographic trends that had to be taken into account by the Trustees when selecting alternative assumptions for financing projections. Primarily as a result of these real-world changes, the system is now projected to have an actuarial deficit over the next 75 years under the intermediate assumptions (Goss, this volume). Table 1 tracks changes in the key intermediate assumptions used since 1983.

One alternative to basing financing changes on a specific point estimate 75 years into the future would be to legislate self-correction mechanisms. Thus as key variables affecting social security financing changed (such as life expectancy for retirees), program provisions associated with those variables (such as the normal retirement age) could automatically change in tandem to keep projected income and expenditures in balance. Sweden, for example, recently indexed its retirement age to changes in life expectancy. In the United States, the 1972 enactment of annual cost-of-living benefit adjustments for increases in prices and indexing of the amount of earnings subject to OASDI taxes (called the “earnings base”) to growth in average wages placed those particular determinants of social security financing on automatic pilot. Thus far, while the theoretical possibility of automatically adjusting other determinants has been mentioned from time to time, it has not been widely considered in practice.

We do not mean to endorse such changes at this point. It is useful, nevertheless, to raise the issue of automatically adjusting the major factors that determine social security financing. The absence of such automatic indexing, combined with the almost certain likelihood that future experience will not be exactly as projected under the Trustees’ intermediate assumptions, means that the system inevitably will move out of balance in a positive or negative direction every few years. This, in turn, could necessitate periodic reconsideration of various policy options to bring the system back into balance. Although in many areas the genius of American politics has been in adjusting programs as needed, the prospect of addressing social security financing every 10 or 20 years is not generally viewed as desirable. Given the inherent uncertainty of 75-year projections, however, aiming for exact financial balance and expecting that balance to be maintained will certainly disappoint and will also push us toward arbitrary changes to achieve periodic exact balances.

Looking backward, a good example of a financing change that appears to have been chosen primarily to satisfy a 75-year point estimate of funding status (rather than being made on policy grounds) is the schedule adopted in 1983 for increasing the retirement age for full social security benefits.
<table>
<thead>
<tr>
<th>Publication</th>
<th>Fertility Rate in 2050</th>
<th>Average Life Expectancy in 2050</th>
<th>Annual Change in CPI</th>
<th>Average Annual Real Wage Differential</th>
<th>Average Unemployment Rate</th>
<th>Disability Prevalence Rate&lt;br&gt;</th>
<th>Real Interest Rate&lt;br&gt;</th>
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<tr>
<td>1997 TR, II</td>
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<td>80.3</td>
<td>3.5%</td>
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<td>6.0%</td>
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<td>1.0</td>
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<td>79.8</td>
<td>4</td>
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<td>6.0</td>
<td>25.9</td>
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</table>

Notes:

a. Principal assumptions include those which have the greatest effect on the actuarial estimates (fertility, mortality, CPI, and disability prevalence rates) and one which draws attention (unemployment rate) but which does not have a major effect on the actuarial balance. In 1984-90 there were two sets of intermediate assumptions which shared the same demographic assumptions but used different economic assumptions; alternative II-B was cited in most policy discussions.

b. Average age-adjusted prevalence rate per 1,000 disability insured workers in 2050, based on 1980 population aged 20-64.

c. Average annual rate for special public-debt obligations issuable to the trust funds.

Source: Data kindly supplied by the SSA Office of the Actuary.
This provision increases the retirement age for people reaching age 62 in 2000–2005 by two months per year for each birth-cohort for six years; makes no further change for 12 years; and then again increases the retirement age by two months per year for another six years. The end result, of course, is to raise the age for full retirement benefits from 65 to 67 by 2027. Two of the financing plans put forth by the last Advisory Council (1997) would eliminate the apparently arbitrary 12-year hiatus in this schedule and index the retirement age after it attains 67 to increases in longevity. Again, we stress that our use of this example does not mean we endorse a specific change; rather, the example shows how premising consideration of financing changes on meeting a 75-year point estimate as of the simple point in time can lead policymakers to enact changes that are not examined on their merits to the extent we might wish.

Is there some other way to keep the system automatically in balance, while recognizing the uncertainty inherent in 75-year estimates, short of indexing everything we can? (Of course, indexing raises other questions, as the debate over the cost of living index illustrates. Here, the question has been, what index should be used and how it should be measured.) We know of no mathematical answer to this question. But we do think the formulation of social security financing policy would produce better results if policymakers and the public came to understand that seeking “exact” actuarial balance at the end of any given 75-year period may dictate policies that otherwise seem questionable. Second, policymakers and the public need to recognize that, because there is no way to predict the future perfectly, even our best efforts at policy changes in any given year can only be approximations that will need periodically to be updated, just as we update the Trustees Report assumptions each year based on recent experience and new information about future trends.

The difficulty and inexactness of making projections over a 75-year period have led some observers to question whether such a forecast should be undertaken at all. Some observers suggest that the 75-year period be shortened, for example. We strongly disagree with this view. Most of the current financing problems facing social security are attributable to major demographic changes, ones that are well established and that will take several decades to unfold. A long projection period, such as 75 years, is essential to assess the full impact such demographic forces will exert on the social security system.

A great difficulty with regularly updating benefit programs like social security is that it is much more difficult to reach political agreement when benefit programs must be adjusted downward or their growth slowed, than it is to create new benefit categories and increase benefits. Nevertheless, it is critical for policymakers and the public to come to accept that social security financing is directly affected by changes in our population and in our economy. It follows that social security financing provisions will have to
change if the factors that affect income and expenditures evolve in ways that are not precisely projected under the Trustees' best estimates—as we know will almost certainly happen over a period as long as 75 years.

**OASDI Projections**

The long-term financial status of OASDI can be measured in several ways. One of the simplest is current cash flow. Under the intermediate (Alternative II) assumptions, income to OASDI from payroll taxes alone is projected to exceed benefits paid in each of the next 15 years. In 2012 and thereafter, payroll tax income plus a portion of annual interest income will be needed to equal annual expenditures. However, beginning in 2019 and continuing through 2029, current tax income plus annual interest plus a portion of the trust fund reserves will be needed to pay benefits. In 2029, the accumulated assets of OASDI will be exhausted. With assets exhausted, tax income in that year is projected to equal about three-quarters of social security benefit costs, and this ratio is projected to decline to about two-thirds at the end of the 75-year projection period in 2071.

A different measure of OASDI's long-term financial status is the percent of total earnings subject to OASDI taxes (called "taxable payroll"). This relative measure is useful because it avoids the difficulty of comparing dollar amounts for different periods. The 1997 Trustees Report indicates that the shortfall in OASDI financing using this measure is 2.23 percent. This number can be interpreted as the required increase in the current payroll tax rate of 12.4 percent—for a total of 14.63 percent—in each of the next 75 years, or the amount that would have to be subtracted from the benefit rate, to bring the system into financial balance.

One significant result of using a 75-year projection period is that in each new Trustees Report, a new, relatively higher, cost year is added at the end of the period. Social security costs are higher in those far distant years because future beneficiaries are anticipated to live significantly longer in retirement than do beneficiaries today. Currently, adding a new distant year to the projection period increases the deficit by .08 percent of taxable payroll. Approximately one-third of the 1997 deficit of 2.23 percent of payroll that has developed since the 1983 Amendments is due to the rolling forward of the projection period into years that have significantly higher costs on average than those between 1983 and 1996. But the value of making 75-year projections—even when we know they cannot be exact—is that these projections alert us to possible changes in economic and demographic conditions long before they occur, giving us time to plan for such changes.

Changes in key demographic and economic assumptions on the OASDI financing projections are also significant. For example, the 1997 Trustees Report assumed that, in the future, women in the United States will have during their lifetime an average of 1.9 children each. A 0.1 change in the
fertility rate assumption changes the long-range actuarial balance by 0.12 percent of taxable payroll. Similarly, a 0.1 percentage point change in the assumption regarding the rate at which wages will rise per year after inflation, changes the balance by 0.11 percent of taxable payroll. Although a change of 0.1 percent is small in any single year, the “magic of compounding” over a 75-year projection makes small changes important. Thus, selecting the assumptions used in projecting OASDI financing is among the most important duties of the Board of Trustees and is based on the best technical advice and analysis available both inside and outside the government. The importance of the process of selecting the assumptions and preparing the projections is recognized in the Social Security Act by requiring that the Chief Actuary of the Social Security Administration provide a written opinion in each report regarding the methods and assumptions used in preparing the report.

Changing the individual components in any set of assumptions can have a significant effect on the financing balance, but often individual changes have offsetting effects. The purpose of having alternative sets of assumptions is to show what would happen if future experience regarding all the assumptions in a set were either more positive or more negative for the financing of the social security program. As would be expected, the effect on the balance of such variation across the whole set of assumptions is large. Thus, while the actuarial balance in 1997 under the intermediate assumptions is −2.23 percent of taxable payroll, the balance under the low-cost (Alternative I) assumptions is +0.21 and under the high-cost (Alternative III) assumptions is −5.54. The range of possible future experience projected under the three sets of assumptions underscores, we believe, the need for policymakers and the public to accept the likelihood that periodic adjustments will be needed, as demographic and economic conditions fluctuate, to keep the social security program financed on a sound basis.

On the positive side, the range established by the three sets of assumptions is intended to cover a wide variety of plausible economic and demographic conditions. This range is not mathematically determined, and no traditional statistical measures can be attached to it. But a critical point to keep in mind regarding the high- and low-cost projections is that if the economic and demographic experience in this country in the next 75 years were to approach the path described by either of those sets of assumptions, every aspect of our society, not just the social security program, would be affected significantly.

**When Is Social Security Financing Change Needed?**

If the system were to be balanced annually, legislation would be needed virtually every year due to the variation in the 75-year projections of OASDI financing that occurs as a result of even small changes in key assumptions.
The Trustees have for many years used a target of "close actuarial balance," where the 75-year summarized cost rate is not allowed to exceed the summarized income rate by more than 5 percent. This concept indicates that some variation in the 75-year actuarial projection is to be expected and does not necessarily require action. Conversely, the "close actuarial balance" concept implies that action to reduce the projected deficit is needed when the deficit exceeds 5 percent. By this test, action has been needed for over a decade, since 1989. The summarized 75-year income rate in 1997 of 13.37 percent of taxable payroll is only 86 percent of the summarized cost rate of 15.60 percent. Furthermore, OASDI costs are projected to rise steadily, even after the baby boom generation's retirement, due to continuing increases in life expectancy. Thus, the need for attention to social security financing is clear, not only because the program is out of "close actuarial balance" but also because the financing shortfall can be expected to increase in each new Trustees Report even if we make no changes in our assumptions about the future.

Another important consideration regarding the timing of action on social security financing is that the sooner changes are enacted, the more broadly can the burden of closing the financing deficit be distributed across different age groups. One way to illustrate this point is that if it were decided to raise payroll taxes in 1998 to eliminate the OASI projected deficit, employers and employees each would have to pay about 18 percent more in all future years (i.e., an OASI tax rate of 6.3 percent rather than 5.35). If such a change were not effective until 2010, the tax rate would have to be increased by almost a quarter (to 6.57 percent), and if delayed until 2025, that tax rate would have to be increased by more than a third (to 7.22 percent). Reductions in benefits or other types of changes would have similar increases in size if their effective dates were delayed. Thus, while we have time to consider carefully what changes should be made in the social security program, we should act as soon as support for a plan can be developed.

What Are the Options to Improve Social Security Financing?

Prior to 1977, social security financing was kept in relative balance by increasing the payroll tax rate and earnings base, and by expanding the fraction of jobs subject to the payroll tax. In 1977 and thereafter, financing provisions were enacted to reduce the growth of future program costs. Examples of such changes include elimination of "faulty indexing" in the computation of benefits in 1977, cutbacks in benefits in the early 1980s, and increases in the normal retirement age in 1983. There are obviously a wide variety of options today for increasing income or reducing the cost of OASDI. To bring social security financing into balance in these ways, however, would require increasing the tax rate, as noted earlier, by about 18
percent throughout the 75-year period, or by reducing benefit costs by about 15 percent—or some combination of the two. That such choices are less than attractive perhaps explains why no legislative action has occurred, even though the system has been out of “close actuarial balance” throughout the decade of the 1990s.

This problem is complicated by the fact that the rising cost of health care has attracted more attention to Medicare than has been given to the social security deficit in recent years. Although the social security program and Medicare are usually considered separately, their financing is closely related. Both depend on the payroll tax for most of their income, and for many retirees the amount of their social security benefit largely determines how much they are able to pay in premiums, deductibles, and co-insurance for health care. Also, both the social security program and Medicare are vying for the same limited resources, and in the long run the shape of both programs will be driven by the same demographic forces that are leading us to an aging society. Given, then, that the options of raising the payroll tax rate or reducing benefit costs each raise hard issues, it is perhaps not surprising that some have tried to find other possible solutions to the social security financing problem.

A different option for social security reform is argued cogently by Bosworth (1996), who proposes increasing the size of the future economic pie, so that the higher costs of retirement can be met with a lower tax rate than would otherwise be necessary. In other words, a richer society can afford a richer social insurance program. One way to accomplish this, Bosworth suggests, is actually to save and invest in equities the billions of dollars by which annual social security payroll taxes currently exceed benefit payments—the trust funds. Bosworth notes that, via the 1977 and 1983 Social Security Amendments, Congress began to move away from a pay-as-you-go system of financing the social security program toward a partial reserve system. An implication of this policy appears to be that assets can be built up in the social security trust fund while the baby boomers are still working, to be used, along with interest earned on those assets, to help pay the cost of the baby boom generation’s retirement.

The problem with Bosworth’s plan, however, is that unless the buildup in social security assets actually increases net national savings and investment, economic growth will not be increased, and the share of the economic pie that will have to be used to pay retirement costs will be unchanged. And experience shows that, immediately following the 1983 amendments, assets of the trust fund rose, but so too did dissaving by the federal government via larger budget deficits. The key to the Bosworth option, then, is to use the buildup in the trust fund reserve to increase national saving and thus economic growth, but not to let the trust fund be offset by larger federal deficits. The recent deficit reduction agreement represents progress, but this
agreement includes both social security income and expenditures in measuring the budget deficit. And since social security income exceeded outgo by $66 billion in fiscal year 1996, this helped offset deficits in the rest of the budget. Increasing national saving requires that the current annual buildup in social security trust fund assets not be used for current consumption.

One way Bosworth seeks to protect the social security trust fund buildup from being offset by the federal budget deficit is to invest the reserves in private securities, rather than in government bonds. Another would be to let individual workers invest a portion of their payroll tax in individual saving accounts, similar to IRAs, or in a limited number of carefully regulated investment funds. These ideas have become, of course, key elements of the financing plans put forth, or suggested for study, by the last Social Security Advisory Council.

The concept of investment of the trust fund reserves in private securities is of particular interest to us, since it is the responsibility of the Board of Trustees under Section 201 (c) of the Social Security Act to “Hold the Trust Funds. . . . Review the general policies followed in managing the Trust Funds, and recommend changes in such policies.” The last major review of trust fund investment policy (in 1960) expressed concern about government investment in private securities, and led the 1960 Advisory Council to recommend that social security trust fund investments be limited to securities backed by the federal government. Since that time, the development of efficient, passively managed, and broadly indexed investment funds may have mitigated some of the earlier concerns. But, thus far, there has been relatively little analysis of the questions that would have to be answered before any change in trust fund investment policy could be accepted. We would like to enumerate a few of those questions in the hope of stimulating additional analysis.

Questions Regarding Investment of Trust Fund Reserves in Private Securities

1. How much would investment risk increase? One of the key arguments for holding trust fund reserves in federal securities (as is presently the case) is that it is the safest investment possible—there is little to no risk of loss of principal. Investment safety is more important for the social security program than for most investors, because it is the basic source of retirement income on which workers rely and to which they are expected to add, if possible, additional retirement income from work-related pensions and personal savings. Thus, safety of investment would seem to be more critical for the social security program than for other investors. Indeed, the safety of social security allows individuals to take more risk in other parts of their retirement savings. If this is so, one must ask whether it makes sense to
expose the social security program to the same risk as pensions and personal saving in private securities.

The principal method of assessing the difference in risk of investing in government bonds versus private securities has been to look at long-term past experience. Such analysis shows both higher rates of return and higher volatility of returns for private securities. This greater volatility would have to be taken into account when designing a plan to invest social security program reserves in private securities. In addition to the financial risk, there also would be considerable political risk. For example, how would Congress and the American public react to a stock market crash, if a significant portion of the social security reserves were invested in equities? As another example, during the period of 1968 to 1982, nominal asset values zig-zagged around a flat trend, but real values after inflation declined substantially.

2. How much additional return could the social security trust fund expect for investment in private securities versus government bonds? The last Advisory Council (1997) relied in its discussions on an analysis of historical experience showing that stocks outperformed government bonds by an average of 4.7 percent per year over the period 1900–95. But, as every financial prospectus tells us, future performance may not resemble that of the past. For example, would historical yield differentials between the equity and debt markets continue with such a reallocation between markets? After all, someone would still have to hold the federal debt that the social security trust funds would no longer be buying.

As Trustees we are well aware of the difficulty of using past experience to forecast the future. In fact, there is no perfect methodology for doing so, and we must be careful to avoid extrapolating from past experience just because it is the easiest thing to do. Nevertheless, it will be critical to reach some broad consensus on the additional return that the trust fund could expect from investing in private securities, if such an investment policy is to be seriously considered by policymakers.

3. Would private investment of the trust fund reserves actually increase net national saving and, if so, by how much? Investment of trust fund reserves in private securities may or may not affect private saving, and the net effect on public saving, or dissaving, is unclear. As difficult as reaching the recent deficit reduction agreement has been, the deficit calculation still includes the social security trust fund reserve annual buildup projected over the next 15 years. Whether a trust fund buildup could be saved over this period would depend not only on continued strong economic performance, but also on convincing policymakers that the federal budget should be balanced exclusive of increases in social security reserves, to raise the national saving rate. This would obviously be a daunting political challenge. Hence, investing the social security trust fund reserves in private securities would not necessarily increase total national saving unless the budget deficit were reduced by a like amount.
4. How much additional economic growth could an increase in net national saving produce? This is, of course, a fundamental macroeconomic question, and one that is currently very much under debate in regard to the economic benefits of implementing a deficit reduction plan. There seems to be some level of agreement that additional national saving produced by reducing the deficit would have a measurable, but small, effect on economic growth in the short term, with the possibility of larger positive effects in the longer run. The problem with measuring the effect of additional saving is that the rest of the economy cannot be held constant while savings increases. Nevertheless, it will be necessary to argue that additional growth would occur if the budget is balanced exclusive of the buildup in social security reserves, so that the buildup can actually have a positive effect on national savings.

5. Could procedures be established for investment of social security reserves in private securities so as to avoid political involvement in investment decisions? A positive aspect of the current trust fund investment policy is that it avoids the need to make choices of sectors, industries, or companies in which to invest. Today, such issues might be avoided even in private sector investment of the trust fund, by investing only in passively managed funds indexed to the broad market. The public is familiar with mutual funds, and they have become the preferred method of investing for many. This undoubtedly makes it easier for people to consider investing the trust fund reserves in private securities, but convincing the public that such investments could be insulated from political interference would be a major hurdle. Moreover, many raise a question of whether governmental ownership of a significant portion of private industry should be considered at all.

6. How would the currently projected need for the social security trust fund to draw down reserves on a predictable schedule as the baby boom retires affect investment in private securities? A fundamental rule of investing is not to put at risk money needed to pay next month's bills, or retirement money that will be needed next year. Yet, under current projections, the social security trust fund will need to draw down its reserves when the baby boom retires. This would appear to limit the possibilities for investment of the reserves long enough to obtain significant additional return, and would also put the trust fund at risk of facing a down market at the time it needs to disinvest. One way to meet this problem would be to invest only trust fund monies not needed to pay current benefits. This solution, however, requires that to make a substantial enough investment to provide significant additional return to the fund, additional amounts would be needed now for the fund to invest. Bosworth proposed raising the payroll tax rate now, arguing that it would reduce the need in the future for greater tax rate increases or benefit reductions. The last Advisory Council also recognized the timing problem and agreed that only trust fund reserve amounts never projected to be needed to pay current benefits should be invested privately. The bottom line seems
to be that wide agreement exists that trust fund assets needed to pay current benefits should not be invested in private markets.

These questions are not intended to be an exhaustive list of the issues that must be resolved before changing the law to allow investment of trust fund reserves in private securities. They do show, however, that both good analysis and good will among policymakers would be required in any effort to allow such a major change in trust fund investment policy.

Arguments over these questions led some members of Congress and supporters of one of the Advisory Council plans to avoid these issues completely, by allowing or requiring workers to invest on their own a portion of their annual payroll tax in personal accounts similar to IRA's. Such individual accounts would transfer to the individual worker all of the issues of risk, return, and administrative cost that would be faced by the social security trust fund if its reserves were invested in private markets. An individual account approach also is attractive to some because it ensures that the federal budget balance will not include the contributions to those accounts. The Board of Trustees may not have any responsibility for such individual savings account plans, but, since we have listed difficult issues regarding trust fund investment in private securities, we acknowledge that there are also similar issues under individual account plans. There are also difficult issues regarding private saving plans, and we list several major ones next:

Questions Regarding Individual Investment Plans for Retirement Income

1. **Is it good social policy to reduce the redistributional elements of social security and to increase links between benefits received and taxes paid into the program?** The social security program has historically provided a balance between (a) relating benefits to taxes paid, and (b) redistribution from higher earners to lower earners and from individual workers to workers with families. The purpose of the redistributional, or "social adequacy," element of the social security program is to ensure that lower-income workers and their families receive an adequate benefit. Individual saving accounts, particularly if funded by a reduction in the payroll tax, would affect this balance by decreasing the redistributive feature of the program.

2. **To what extent should options for investment of workers' saving be limited to a set of passively managed, broadly indexed funds?** Such a limitation would reduce the time and information that workers would need to devote to their investments and reduce the possibility of poor return as a result of bad luck or poor individual investment decisions. However, such a limitation would be resisted by some as an unacceptable reduction in individual freedom in investing personal assets.

3. **What, if any, would be the government's responsibility for investment return?** In
Chile, for example, the government guarantees a relative annual rate of return on workers' investment in mandatory private saving funds and a minimum pension benefit (Turner and Watanabe 1995; Pennacchi, this volume). If the U.S. markets experienced another period like that between 1968 and 1982 when the equities market was virtually flat, people retiring in those years might view the result as unfair and expect government action on their behalf.

4. How much of a worker's investment for retirement should be subject to market risk? Private pensions in the U.S. have been moving from defined-benefit to defined-contribution plans for a number of years, thereby making pension benefit depend on market performance. If social security were to become partly a defined contribution plan, this would subject more of workers' retirement income to market risk or the risk that some workers would invest too conservatively to achieve the average rate of return available over past periods.

5. How much enforcement and regulation would be needed if all workers were required to invest in private plans on their own? Since the government would have residual responsibility for retirement income through needs-based plans, it would be important to ensure a high degree of compliance with individual investment account requirements.

6. What would be the administrative cost for individual investors? There is virtually no administrative cost for social security trust fund investment in government bonds, whereas the cost of administering individual investment accounts for 145 million workers would be larger. Could ways be found to reduce those administrative charges? What would be fair compensation to private money managers for "social security" accounts? Do the advantages of such a program outweigh the considerable extra administrative expenses that would be incurred? Answers to these queries are not yet known.

7. Would people be required to annuitize their saving at retirement to ensure a stream of payment however long they lived beyond that point? If so, could a broad market for such annuities be developed and administrative charges held down? If not, what would be the additional cost to government needs-based programs for those who exhausted their individual savings? Experience in the private sector teaches us that assets in defined-contribution plans are rarely used to provide periodic lifetime income.

8. Will mandating private savings for retirement translate into an increase in national savings? As people see funds build up in their individual accounts for retirement, they may reduce savings elsewhere. Also, people may demand and receive the right to use these individual account funds for purposes other than retirement income. How such factors evolve could reduce the positive economic effects that private savings accounts are often promised to produce.

As these questions illustrate, requiring individual workers to have private accounts raises a different set of thorny issues, ones no simpler than those
compared to the ones that arise if the social security Trust Fund were to buy equities.

**Conclusion**

We join with other members of the Board of Trustees in calling for timely action to resolve the projected long-term social security financing problem. Although the OASDI system is projected to be able to pay benefits for many years, we need to develop policy options soon. Early action should be taken for several reasons. First, the earlier changes are implemented, the more incremental they can be. Second, implementing changes soon would permit time for phasing them in and for workers to adjust their retirement plans. Third, there has been an alarming erosion of public confidence in the social security system over the past few years, particularly among younger generations (see Quinn, and Rother and Wright, this volume). Early attention to the social security program’s longer range financing problems is vital to restore public confidence in the program.

As Public Trustees we are quite disturbed about the public’s loss of confidence that the social security program will be there for future generations. And, if the public is convinced (rightly or wrongly) that the social security program will not be there when it reaches retirement age, it may feel that it has no option but to replace the program.

New approaches regarding social security financing fall outside the traditional “box” of tax increases and benefit reductions to meet rising retirement costs. They center on increasing national saving to increase economic growth, so that the cost of retirement when the baby boom generation retires and beyond will require a smaller portion of national income than it otherwise would. With a larger economic pie and higher wages, a given payroll tax rate will provide more income to the trust fund to pay benefits. To achieve this result, the income that the trust fund receives in excess of current needs would have to be added to national savings, and this can occur only if that excess is not offset by increases in federal budget deficits. Fortunately, the prospects for this change appear better now than at any time in recent years, but there is still a long way to go to reach that objective.

Faster economic growth would also increase the attractiveness of investing the Trust Fund reserves in private securities. An alternative would be to allow workers to invest a portion of their payroll taxes in private savings accounts. Either alternative could channel part of the additional growth into retirement income, but both approaches raise very tough questions that would need to be resolved before agreement on such changes could be reached.

It would be foolhardy to rush to judgment on these new approaches for meeting the rising costs of retirement, but it is vital that informed debate help resolve long-range social security balance. We cannot reliably predict
the future. But reaching agreement on changes will be easier, if we recognize that searching for a set of changes that meet a specific point-estimate 75 years into the future is less important than moving ahead soon with those changes that seem to make the most sense, with full realization that the social security program cannot be insulated from all future social and economic change. The strength of the social security program is that it can adapt as our national circumstances change; our acceptance of the necessity for change is more difficult, eased only by having the information needed to believe that we understand why change is necessary and in which direction it should take us.

References


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