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This is the first in a series of RPC papers on Social Security reform.

Rising to Meet the Challenge Social Security Poses to Younger Workers

- The current Social Security system is unsustainable and patently unfair to younger workers. Recognizing these facts, the President established a commission in 2001 to provide specific recommendations for improving the system. This paper analyzes the problems with the current system and the commission's three reform models.
- The Social Security system faces a \$10.4 trillion shortfall in net present-value terms. This means that the government would have to put away \$10.4 trillion today, earning prevailing rates of interest, to fund future Social Security benefits. Since Social Security is financed on a pay-as-you-go basis – current workers' taxes fund current retirees' benefits – longer life expectancy and lower birthrates will bankrupt the system as currently configured.
- According to the 2004 Social Security Trustees' Report, beginning in 2018, Social Security's scheduled benefits will exceed the amount of payroll taxes collected, then requiring transfers from the General Fund of the Treasury if benefit payments are to be made in full.
- Between 2018 and 2042, the General Fund will have to provide over \$5 trillion in transfers for Social Security in addition to funding the rest of the federal government. This will require higher taxes, lower spending on other programs, larger deficits, or some combination of the three.
- Worse, after more than \$5 trillion in General Revenue transfers, by 2042 the Social Security Trust Fund will be completely exhausted, requiring an immediate 27-percent cut in Social Security benefits – in accordance with current law.
- To avoid this outcome, the President's commission offered three models to transform Social Security from a purely pay-as-you-go system to one in which workers would partially pre-fund their *own* retirement through personal accounts. These accounts would relieve some of the financing burden facing future workers, and would convert scheduled benefits from political promises to tangible assets.

Introduction

During his first post-election news conference, President Bush reiterated that reform of Social Security “will be a priority,” and he cited the “blueprint” provided by the commission co-chaired by the late Senator Daniel Patrick Moynihan as a “good place for Members of Congress to start.”¹ In an effort to help Senators prepare for the upcoming debate on the future of retirement security, this paper examines that blueprint’s recommendations.

The Commission to Strengthen Social Security (the Commission) was established on May 2, 2001, and released its final report on December 21 of that year. It included a long list of unanimously agreed-to findings and three proposals to modernize Social Security through the introduction of personal retirement accounts.² As Senator Moynihan and his co-chairman, Time Warner CEO Richard D. Parsons, wrote in the report’s introduction, “The details of such accounts are negotiable, but their need is clear.”³

The Commission based its assertion that personal accounts are needed on two facts: 1) the system, as currently configured, is not sustainable due to demographic realities; and 2) Social Security no longer provides a reasonable return on workers’ payroll tax contributions. The commission found that personal investment accounts would confront both problems. By allowing workers to partially pre-fund their future benefits, personal accounts provide the potential to keep the program solvent without the need for debilitating tax increases or sudden benefit cuts that would be necessary to close the \$10.4 trillion (in present value) shortfall that exists under the current configuration.⁴ Similarly, personal accounts would offer current middle-income workers the ability to seek a higher rate of return than the paltry 1 percent to 2 percent that the current system can provide on their payroll tax contributions.⁵

Today’s Social Security: Too Much for Too Little

Understanding the public policy challenge posed by demographic change can, at first blush, seem paradoxical: How can Social Security cost too much *and* provide too little in return at the same time? This is because the program’s pay-as-you-go basis – current workers’ taxes fund current retirees’ benefits – requires that workers be taxed at a rate necessary to finance the benefits collected by retirees *at that point in time*. Thus, a large intergenerational imbalance burdens current workers with higher tax rates without providing a commensurate increase in the benefits that those workers themselves will receive.

¹ President George W. Bush, Presidential Press Conference, November 4, 2004 (transcript available at: <http://www.whitehouse.gov/news/releases/2004/11/20041104-5.html>).

² The President’s Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, Final Report of the President’s Commission, December 21, 2001, (available at: http://www.csss.gov/reports/Final_report.pdf).

³ Final Report, p. 9.

⁴ 2004 OASDI Trustees’ Report. Actuarial Tables.

⁵ The SSA estimates that a 32-year old single male can expect an internal rate of return of 1.74 percent on his payroll tax contributions. As part of a two-earner couple, the internal rate of return on their combined payroll tax contributions would rise to 2.11 percent. Orlo R. Nichols, Michael D. Clingman, and Milton P. Glanz, “Internal Real Rates of Return Under the OASDI Program for Hypothetical Workers,” Social Security Administration, Actuarial Note 144, June 2001.

The demographic shift that forms the foundation of Social Security's future problems cannot simply be explained in the context of the baby boom generation being significantly larger than generations that succeed it. In fact, estimates suggest that the problem will actually *worsen* throughout Social Security's 75-year projection period.⁶ More precisely, this problem is the manifestation of a fundamental shift in life-expectancy and birth rates, and is in no way limited to the retirement of the baby boom generation. For example, when the last baby boomer turns 65 in 2025, the ratio of workers-to-beneficiaries is expected to be 2.3, but will fall below 2 just over 35 years later.⁷

When there are more than eight workers per beneficiary – as was the case 50 years ago – the tax rate necessary to finance benefits is much lower than when that ratio drops below three workers per beneficiary – as it is expected to do in the next 10 years.⁸ And as the ratio of workers-to-beneficiaries declines, the program's cost rate – the total amount of scheduled benefits divided by the total payroll on which taxes are levied – increases proportionally.⁹ But because the costs of benefits for one generation are borne by another, as the cost rate increases, the internal rate of return on individuals' Social Security contributions declines. This is why Americans retiring in 1970 enjoyed rates of return in excess of 10 percent, while those born in 1960 can expect average returns of about 2 percent.¹⁰ Some workers born today can expect a *negative* return on their payroll tax contributions.¹¹

Trust Fund Operations

According to the 2004 Social Security Trustees' Report, Social Security's cost rate is expected to eclipse its tax rate of 12.4 percent in 2018.¹² This means that, beginning in 2018, Social Security's scheduled benefits will exceed the amount of payroll taxes collected, and that transfers from the general fund of the Treasury *will be necessary* if benefit payments are to be made in full. In other words, even if Congress does nothing, some sort of "transition costs" are inevitable.

Currently, Social Security's payroll tax rate exceeds the program's cost rate, resulting in surpluses. This has been the case since Congress passed the Social Security Act Amendments of 1983 (P.L. 98-21). In accordance with this statute, the Social Security Administration has "invested" these surpluses in Treasury bonds.¹³ However, these "investments" are really just accounting transactions that do nothing to improve the government's ability to finance future benefits.¹⁴ In reality, Social Security surpluses are loaned to the General Fund of the Treasury to

⁶ 2004 OASDI Trustees' Report. Actuarial Tables.

⁷ 2004 OASDI Trustees' Report.

⁸ 2004 OASDI Trustees' Report. Actuarial Tables.

⁹ *The Economic Report of the President 2004*, Chapter 6.

¹⁰ Alan Greenspan, Federal Reserve Chairman, "Investing the social security trust fund in equities," in testimony before the Subcommittee on Finance and Hazardous Materials, Committee on Commerce, U.S. House of Representatives, March 3, 1999.

¹¹ Nichols, Clingman, and Glanz.

¹² 2004 OASDI Trustees' Report. Actuarial Tables. This 12.4 percent includes both the employee and employer payroll tax contribution (minus the 2.9 percent HI contribution dedicated to Medicare).

¹³ For a more complete description of the 1983 Amendments, see: <http://www.ssa.gov/history/1983amend2.html>.

¹⁴ Others contend that Social Security surpluses *do* increase the government's ability to finance future benefits because they reduce the amount of debt held by the public, resulting in higher national savings. There is little or no

finance current, non-Social Security spending in exchange for interest-bearing special obligation bonds.¹⁵

As President Clinton's Fiscal 2000 year budget explained:

[Trust Fund] balances are available to finance future benefit payments and other trust fund expenditures – but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury, that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, make it easier for the government to pay benefits.¹⁶

When the Social Security Administration begins cashing in these bonds in 2018, their total value is expected to exceed \$5 trillion.¹⁷ But they are “cashed in” by having taxpayers fund them. And because Trust Fund balances will, in a technical sense, continue to earn interest during this period, over the next 24 years the general fund will need to come up with more than \$12 trillion in transfers for Social Security in addition to funding the rest of the federal government.¹⁸ This will require higher taxes, lower spending on other programs, larger deficits, or some combination of the three. Worse, by 2042 the more than \$5 trillion in Trust Fund bonds will have been fully redeemed, causing an immediate 27-percent cut in Social Security benefits, unless current law is changed.¹⁹ Under current law, many of today's workers and those future generations will not only have to fund the more than \$12 trillion in accumulated obligations through the general fund, but also risk sharp benefit cuts at the time of their retirement.

Personal Accounts Offer a Solution

Given this grim reality, it is somewhat astonishing that any policymaker would choose to peremptorily dismiss alternative courses. Writing in *The Washington Post*, former Senators Bob Kerrey and Warren Rudman ridiculed those who dismiss alternatives by equating dismissal to sponsorship of the “Social Security Do Nothing Act,” whereby “promised retirement benefits would be cut by 16 percent for today's 30-year-olds, by 29 percent for today's 20-year-olds and by 35 percent for today's newborns.”²⁰ Support for “doing nothing” is even more confusing given the

empirical support for this contention, however. See Kent Smetters, “Is the Social Security Trust Fund Worth Anything?” University of Pennsylvania and NBER, June 2003.

¹⁵ These bonds bear interest at a rate equal to the average rate of interest, computed as of the end of the calendar month next preceding the date of such issue, borne by all interest-bearing obligations of the United States then forming part of the public debt; except that where such average rate is not a multiple of one-eighth of 1 per centum, the rate of interest of such special obligations shall be the multiple of one-eighth of 1 per centum next lower than such average rate. See SSA: http://www.socialsecurity.gov/OACT/TR/TR04/VI_cyoper_history.html.

¹⁶ Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000*, Analytical Perspectives (Washington, D.C.: U.S. Government Printing Office, 1999), p. 337; emphasis added.

¹⁷ 2004 OASDI Trustees' Report. Actuarial Tables.

¹⁸ This is the estimated cumulative shortfall between OASI revenue and outlays between 2018-2042. Since Trust Fund assets will continue earning interest during the period, every General Fund dollar transferred to Social Security reduces the Trust Fund balance by less than one dollar and the total amount of needed General Fund transfers is far greater than \$5 trillion. SSA data compiled by the Senate Committee on Finance.

¹⁹ 2004 OASDI Trustees' Report. Projections of Future Financial Status. Current law requires that once the Trust Fund is exhausted, annual benefit levels are reduced to match annual revenues.

²⁰ Bob Kerrey and Warren Rudman, “Social Security Shell Game,” *The Washington Post*, August 12, 2002.

fact that the President's 2001 Commission proposed three pre-funding plans that would not only improve Social Security's sustainability, but also would offer workers greater benefits that they would own and be able to pass on.²¹

The Commission's plans would convert Social Security from a purely pay-as-you-go system to one in which workers would partially pre-fund their *own* retirement through personal accounts. These accounts would relieve some of the financing burden facing future workers, and would convert scheduled benefits from political promises to tangible assets. By swapping scheduled benefits for real assets, the program's cost rate would be reduced and a portion of workers' contributions would earn market-based returns.

The Commission's Three Reform Models

Although all three Commission proposals involved personal accounts, they differed in other respects – the size of such accounts, and the effects that programmatic changes would have on Social Security's solvency and the unified budget deficit. It is important to note that all three reform models guarantee current benefits for those 55 years of age and older, while limiting new account eligibility to those workers under that age.

Reform Model 1

Reform Model 1²² would allow workers to invest 2 percent of their taxable payroll income into personal accounts under a new *optional* Social Security Part B. Benefits provided under the current system, henceforth to be known as Part A, would be offset by the dollar amount contributed to the Part B accounts, compounded at an annual rate of 3.5 percent. If Part B accounts earned an average annualized *real* (inflation-adjusted) return greater than 3.5 percent over the worker's remaining time in the workforce, he would get higher retirement benefits. If a worker's account earned less than an annualized real average of 3.5 percent, benefits would be reduced by the difference between actual returns and the 3.5-percent compounded rate. As a point of reference, the lowest-ever annualized real return over a 20-year period for the S&P 500 was 3.1 percent, while the highest average real return was 17.1 percent.²³ Workers who elect not to open a Part B account would receive the same level of benefits that they are currently promised.

The primary advantage of this model is political: the accounts are small, entirely optional, and the changes to the current system are the least dramatic. This, of course, is also the primary weakness with the model: as the commission noted, this model would not achieve long-term solvency – and it would actually increase Social Security's general revenue requirements by 4 percent in present-value terms.²⁴ This is because the future savings from personal accounts will come too late to offset the initial cost of diverting payroll tax revenues to them. Although it would permit younger workers to earn a market-based return on a portion of their payroll tax

²¹ For more discussion about the role bequeathable personal accounts can play in narrowing the wealth gap that exists in America, see: "A Nation of Owners and Savers," Senate Republican Policy Committee, May 1, 2003, available at: <http://rpc.senate.gov/files/SOCIALjt050103.PDF>.

²² Final Report, p. 109.

²³ Bryan Olson, CFA, *Schwab Center for Investment Research*. Every 20-year rolling calendar period for the S&P 500 Index was studied from 1926 through 2002, using annual total return data and rolling forward in annual increments.

²⁴ Final Report, Fiscal Sustainability Results.

contributions, Model 1 demonstrates the pitfalls of introducing personal accounts without reform of the underlying system.²⁵

Reform Model 2

Reform Model 2²⁶ would permit workers to invest 4 percent of their taxable payroll income (up to a maximum of \$1,000 annually) in new Part B accounts. Workers who elect to open accounts will have their Part A benefits offset by the dollar amount contributed to the Part B accounts, compounded at an annual rate of 2 percent. If their Part B accounts grew at a faster rate, workers would receive increased retirement benefits, and, as with Model 1, if a worker's account returned less than a 2-percent annual average, his benefits would be reduced by the difference.

As a study commissioned by the National Center for Policy Analysis makes clear, any regulated portfolio failing to return more than 2 percent per year would be a statistical anomaly.²⁷ According to the study, which analyzed 35-year periods of stock and bond returns since 1871, the annualized, real return on a portfolio containing at least 60 percent stocks could be expected to exceed 2 percent about 98 percent of the time, and exceed 2.5 percent about 93 percent of the time. Importantly, the study also found that approximately 84 percent of portfolios with a 60/40 stocks-to-bonds split could be expected to earn annualized, real returns of greater than 4 percent, with approximately 16 percent of all portfolios earning more than 6.2 percent.

Model 2 would also reform the existing system (Part A) by replacing the current initial benefit calculation for *future* beneficiaries, based on wage growth,²⁸ with an inflation index beginning five years after the reform becomes law. Since wages typically grow faster than prices, this reform will slow the *growth* of future initial Social Security benefits, but will ensure that the purchasing power of future retirees' benefits is at least as great as that enjoyed by today's beneficiaries. In exchange, a new minimum benefit would be created to guarantee that future retirees' benefits will be at least 120 percent of the poverty level. No guarantee exists currently.

The key advantages of Model 2, are, based on the commission's findings, that it restores Social Security to permanent solvency and it increases the system's progressivity, bolstering its social insurance function. In the words of President Franklin Roosevelt, Social Security was created to "give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age."²⁹ Since, under Model 2, more Americans' retirements would be financed through investment income on assets they own, a greater portion of future payroll tax revenues could be used to supplement lower-income retirees' benefits and fulfill Social Security's original mission. Model 2 intends to substantially reduce the poverty rate among seniors, which was estimated to be 10.3 percent for 2003.³⁰

²⁵ The American Association of Retired Persons (AARP), for instance, supports the addition of personal accounts as an add-on to the existing Social Security system. "AARP Opposes Bush Plan to Replace Social Security With Private Accounts," *The New York Times*, November 12, 2004.

²⁶ Final Report, p. 119.

²⁷ Liqun Liu, Andrew Rettenmaier, and Zijun Wang, "Social Security and Market Risk," NCPA Policy Report No. 244, July 2001.

²⁸ For information on how initial benefits are currently calculated, see: <http://www.socialsecurity.gov/OACT/COLA/AWI.html>.

²⁹ Statement of President Franklin D. Roosevelt, August 14, 1935.

³⁰ The Census Bureau, "Income, Poverty, and Health Insurance Coverage in the United States: 2003," available at: <http://www.census.gov/prod/2004pubs/p60-226.pdf>.

Model 2's liability appears to be primarily political, as the switch from wage-indexing to price-indexing could be mislabeled as a benefit "cut." This line of argument is incorrect for three reasons. First, wage-indexing for initial benefits was established in 1977 (Social Security Act Amendments of 1977, P.L. 95-216) when rapid inflation and low productivity caused prices to increase faster than wages for four consecutive years.³¹ In this environment, wage indexing was implemented to *cut* costs, albeit temporarily, as continuation of the price-indexing formula adopted in the 1972 Social Security Act Amendments (P.L. 92-336) was expected to bankrupt the system.³² As inflation has subsided and productivity growth accelerated, it is now the wage-indexing formula, implemented in a time of vastly different macroeconomic circumstances, which threatens the health of the system.

The second reason that it is incorrect to view this reform as a cut is that a reduction in a rate of increase is not a real cut. That is, the correct way to view what the current system (if left unchanged) yields is *not the same* benefits as what today's retirees receive, but, rather, far *greater* real benefits. For example, a person with average wages retiring at age 65 this year will receive an initial annual benefit of about \$14,000, but the initial annual benefit of a similar person retiring in 2050 is scheduled to rise by over 40 percent, even after adjusting for inflation.³³

The third and final reason why this reform should not be viewed as a "cut" is that workers opting for Part B accounts under Model 2 with a balanced portfolio of 50 percent equities, 30 percent corporate bonds, and 20 percent Treasury bonds would likely earn higher Social Security benefits than they would under wage-indexing. For example, when using the real rates of return recommended by Social Security's Office of the Actuary, a low-income worker retiring in 30 years opting for Part B would not only enjoy benefits 40 percent higher than a low-income worker retiring today, but also 10 percent higher than the benefits he would have received under wage-indexing.³⁴

Reform Model 3

Reform Model 3³⁵ would allow workers to invest an amount equal to 2.5 percent of their taxable payroll income (up to a maximum of \$1,000 annually) in Part B personal retirement accounts if, and only if, they also agree to invest an additional 1 percent of their taxable payroll wages in that account. Workers who elect to open accounts will have their Part A benefits offset by the dollar amount contributed to the Part B accounts, compounded at an annual rate of 2 percent. However, this offset would not include the additional 1-percent savings requirement. If their Part B accounts grew at a higher rate, workers would receive increased retirement benefits, and, as with the other plans, if workers' accounts returned less than a real, annually-compounded

³¹ Neil A. Stevens, "Indexation of Social Security Benefits – A Reform in Need of Reform," Federal Reserve Bank of St. Louis, June/July 1981.

³² James W. Kelley and Joseph R. Humphreys, "Congressional Intent Concerning the 'Notch' Issue: Legislative Background of the 1977 Social Security Amendments," Social Security Administration, available at: <http://www.ssa.gov/history/notchfile3.html>. Alan Jacobs, "Reforming American Pensions: 1977 and 1983," University of British Columbia. Available at: <http://www.politics.ubc.ca/jacobs/Jacobs%20Thesis%20Chapter%209.pdf>.

³³ Gregory Mankiw, Chairman of the Council of Economic Advisers, in a speech at the American Enterprise Institute, December 2, 2004.

³⁴ Final Report, p. 123.

³⁵ Final Report, p. 131.

2.5 percent, the benefits of these workers would be reduced by the difference. However, due to the additional 1 percent of payroll investment required to join the Part B, Model 3 makes it even less likely that a worker who opts for personal accounts will experience losses relative to expected benefits.

Model 3 also makes several reforms to the Part A system. First, initial benefits would grow at a rate halfway between a wage index and a price index. Secondly, benefit levels would be adjusted to encourage more workforce participation among 62-70 year olds by rewarding those who retire later with higher benefits. Third, benefits for higher-income retirees would be reduced in exchange for a guarantee that the benefits of retirees who worked 30 years would be at least equal to 100 percent of the poverty rate. Finally, Model 3 would require general revenue transfers averaging 0.63 percent of taxable payroll over the next 75 years. The Commission did not specify how these transfers should be financed.

Although Model 3 does not achieve solvency without substantial scheduled transfers from the general fund over the next 75 years, it does advance several policy goals many believe to be essential to any reform: increasing the national savings rate through the 1-percent “add-on” requirement; and increasing the workforce participation rates for Americans in their 60s. However, both of these changes will likely be attacked by critics. The 1-percent “add-on” requirement could be seen as penalizing lower-income workers who are least able to divert income to savings, while the initial benefit adjustment could be seen as an increase in the retirement age since workers would have to wait until age 70 to claim “full” benefits.

Temporary Transition Investments

Just as all three Commission proposals would reduce the unfunded liability facing future generations, all three would require temporary transition investments to cover the cost of reform. However, there is no precise meaning for transition investments or “transition costs.” According to the Social Security Trustees’ 2004 report, the revenue generated from Social Security payroll-taxes plus the taxation of Social Security benefits will total \$6.2 trillion over the next 10 years, while Social Security retirement benefits plus administrative expenses are expected to be \$5.2 trillion over the same period.³⁶ Technically, \$1 trillion of dedicated Social Security tax revenue could be diverted to personal accounts over the next 10 years without affecting the system’s ability to pay benefits, or tapping general revenues.

However, this is not entirely a realistic way to approach the temporary funding problem since current Social Security tax revenue is used to finance government spending wholly unrelated to retirement benefits. Because there will be less Social Security payroll taxes to devote toward unrelated spending, the government will have to borrow if it wishes to maintain current spending levels.³⁷ Cognizant of contemporary budgeting, the Commission defined the “transition” as the

³⁶ Trustees’ Report, Actuarial Estimates. Note: these figures apply only to Old-Age Survivors’ Insurance (OASI) taxes and benefits, not Disability Insurance (DI). Reform of Social Security Disability Insurance is beyond the scope of this paper.

³⁷ This means that the General Fund will have to borrow from another source (the public, i.e. deficit financing), that other taxes must be raised, or that spending levels be must reduced. Note that this problem will exist after 2018 even if no changes are made to Social Security.

period of time when the new system's cash needs are greater than the needs of the current system.³⁸

Based on this definition, and an estimated two-thirds Part B participation rate for those eligible, the Commission estimated the temporary financing investments required to be: for Model 1, \$1.1 trillion; for Model 2, \$0.9 trillion; and for Model 3, \$0.4 trillion (total transition investments, in present-value terms). Although all three models would greatly improve the long-term financing outlook while allowing younger workers to escape the inequities of the current system, Model 2 would allow policymakers to eliminate completely the program's \$10.4 trillion present-value shortfall in exchange for a temporary investment of less than one-tenth of that amount.³⁹ Moreover, according to the Congressional Budget Office, under Model 2 the debt incurred to finance the transition will begin to be paid off by 2052, with the program running large surpluses from that point forward.⁴⁰

Conclusion

The current Social Security system is unsustainable and patently unfair to younger workers. Recognizing this fact, the President established a commission in 2001 to study the issue and provide specific recommendations for improving the system. The Commission's final report, issued three years ago, is a thoughtful and well-prepared study, and provides policymakers with the perfect starting point for thinking about how best to exit the current policy trap.

³⁸ Final Report, p. 103.

³⁹ If more than two-thirds of eligible workers participate, more transition financing would be necessary, but the system would return to positive cash flow at an earlier date.

⁴⁰ CBO, "Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," July 21, 2004, available at: <http://www.cbo.gov/showdoc.cfm?index=5666&sequence=0#figure1A>.