

A Social Security Plan For All by Robert C. Pozen

I. Multiple Goals

The goals for reform of Social Security (SS) are different for Republicans and Democrats, but they can be reconciled to a significant degree under a new proposal called PIBA -- Progressive Indexing with Balanced Accounts.

- Republicans say that long-term SS deficits are so large that most young Americans feel they would receive few, if any, SS benefits at retirement.
- Republicans therefore suggest that workers be allowed to allocate a modest portion of the 12.4% they pay in FICA taxes to a personal retirement account.
- Democrats are concerned about any allocation of FICA taxes to personal accounts because these taxes are needed to pay SS benefits to current retirees.
- Democrats especially want to protect the SS benefits of low-wage workers, usually without 401(k) plans or IRAs, who depend primarily on SS for retirement income.
- Both parties do not want to change the SS benefits of anyone already in retirement or any worker close to retirement (older than age 55 in 2004).
- Both parties want to reduce substantially the 75-year deficit of SS, the standard period for measuring SS solvency, which has a present value of \$3.8 trillion.

II. Progressive Indexing

After workers retire and begin to receive SS benefits, these benefits are increased each year by COLAs (cost of living adjustments) -- reflecting increases in consumer prices each year. This is called price indexing. By contrast, when the initial SS benefits of workers are set at the time of their retirement, their average career earnings are adjusted upward by the amount wages have increased during their careers. This is called wage indexing.

Progressive indexing means the continuation of wage indexing for all workers retiring in 2012 and later years whose career earnings average \$25,000 per year or less (indexed to wages over time). All these low-wage workers would receive the SS benefits they are presently scheduled to receive under present law (scheduled benefits). Most of these low-wage workers do not have sources of retirement income other than SS -- e.g., 401(k) plans or IRAs. Progressive indexing would also maintain current schedules for SS benefits for all retirees and all those retiring before 2012.

The initial benefits of all workers with career earnings above \$113,000 per year in 2012 (the maximum wage base subject to FICA taxes in that year) would be increased by price indexing -- the rise in prices during their working careers. These workers are relatively well off; most receive retirement income from 401(k) plans and IRAs in addition to SS benefits.

The initial benefits of workers above \$25,000 per year and lower than \$113,000 per year in average career earnings would be increased by a proportional mix of wage and price indexing. For example, a worker with career earnings of \$69,000 per year would have his or her SS benefits adjusted upward approximately 50% by wage indexing and 50% by price indexing.

As a result, the SS benefits of middle and high earner would not grow as quickly as their scheduled benefits would have otherwise. But this should not be termed a "cut" for two reasons. First, the SS benefits of these workers in 2012 and later years will be higher, in nominal and real terms, than their SS benefits would have been had they retired in 2004 with the same average earnings during their careers. Second, these workers will have the option (but not requirement) to earn back most (and perhaps all) of their scheduled benefits through a combination of their slower growing SS benefits and the payments from their balanced accounts, as explained below.

III. **Balanced Accounts**

Balanced accounts (BAs) provide a way for middle and high earners to invest a portion of their FICA taxes in publicly traded securities to make up for the slower growth in their SS benefits. Specifically, workers will be given the choice of allocating to a BA 2% of their wages subject to FICA taxes (\$90,000 in 2005 and rising annually), up to \$3,000 per year (indexed to price inflation over time). The BAs would be invested in a broadly diversified portfolio of US stocks and high-quality bonds (as described below). In return, workers choosing to make allocations to BAs would have to agree to accept a lower payout of SS benefits than they would have received otherwise under progressive indexing. Since such workers would be paying lower amounts into the SS system, their SS benefits would be reduced by such amounts plus interest (at the rate of long-term US Treasury bonds during the relevant years). On the other hand, these workers would receive retirement benefits from their BAs as well as from the traditional SS system.

The BA would be invested in a portfolio composed 60% of the Wilshire 5000 Index representing all publicly traded stocks in the US, and 40% of the Lehman Aggregate Bond Index representing a mix of government bonds, investment-grade corporate bonds and high-quality mortgage-backed securities. Some critics have claimed that the US stock market cannot easily absorb the stock investments implicated by the creation of the BAs. But the BAs would invest only 60% of their assets in stocks and annual contributions to BAs would average around \$1,000 per year. If we estimate that approximately two-thirds of the 100 million American workers would choose to contribute yearly to BAs, this would mean an annual inflow of only \$40 billion per year from BAs into the US stock market -- a small fraction of a multi-trillion dollar market. Other critics have warned that workers with BAs would fare badly if they happen to retire in a year, like 2002, when the US stock market is down sharply. To minimize this potential problem, the 60% portion of the BA invested in stocks would be automatically reduced by 10%

per year starting in the fourth full year before a worker's earliest retirement age. Thus, during the last year before retirement, the BA would be composed 20% of stocks and 80% of bonds.

Of course, every securities portfolio involves some risks, but many critics have confused the significant risk of year-to-year volatility in stock prices with the modest risk that a broadly diversified portfolio of stocks and bonds, like the BA, will not produce its expected return over the whole career of most workers -- spanning 30 to 40 years. According to the standard projections used by SS actuaries, the BA as described above is highly likely to produce returns of 5.2% per year after inflation. This is based on a projection of annual returns after inflation of 6.5% on US equities, and 3.3% on a portfolio of high-quality bonds -- 40% in US government bonds and 60% in high-quality corporate bonds. This projection of annual returns of 5.2% after inflation is then reduced to annual returns of 4.9% after inflation by subtracting total fund expenses of 30 basis points per year -- the management fee plus other operating expenses for the BAs. These total expenses for BAs are the same as those estimated by the Chief Actuary of SS for the President's Commission to Strengthen Social Security ("Presidential Commission").

Are these projections realistic? The 30 basis points per year in expenses for the BAs are higher than the total operating expenses of many index funds -- which are as low as 10 basis points per year for individual investors. Annual returns of 4.9% (after expenses and inflation) projected for the BAs are also lower than the historical experience of investing in similar balanced portfolios over 35-year periods. If workers starting employment in 1952, and every three years thereafter until 1970, invested 2% of their FICA wages for the following 35 years of their working careers in a BA as described above, their pre-inflation returns after expenses would have ranged from 7.46% to 9.39% per year. It is hard to project an accurate rate of inflation, but the Chief Actuary of SS uses an average of 3% per year. If we apply a 3% inflation rate to the BAs held by these cohorts of workers, they would have received annual returns after expenses and inflation ranging from 4.46% to 6.37% per year -- largely above the 4.9% in annual returns after expenses and inflation projected for the BAs.

Following the recommendations of the Presidential Commission, the BAs would be run by the trustees of the Federal Thrift Plan at least for the initial five years of PIBA. The trustees of the Federal Thrift Plan would contract with experienced money managers to invest the pool of monies contributed by all BAs. The Federal Thrift Plan currently contracts out the management of five index funds in this manner. The Plan's operating expenses are less than 7 basis points per year, though its expenses do not take into account all the costs that would be involved in implementing a system of BAs.

The trustees of the Federal Thrift Plan will receive monies and directions on BA investments once a year from the Internal Revenue Service, which will include a new line on all personal income tax forms (as well as a new form for wage earners not filing Federal income tax forms). This new line will allow wage earners to indicate each year whether they would like to allocate 2% of FICA wages to a BA. However, if a worker decides to make such an allocation in a BA in any given year, the 2% of their FICA wages allocated to his or her BA for that year would remain invested in the BA until he or she retires.

This approach to implementing PIBA is designed to start the BAs with low administrative expenses. This approach would also have the advantage of not changing in any way the system whereby employers presently forward FICA taxes to the Treasury. After the initial five years, Congress may decide to open up PIBA to BAs managed by private firms. However, Congress would be likely to impose certain limits on investment choices by BAs and other conditions in light of the experience with BAs administered by the Federal Thrift trustees.

At retirement, the BAs would presumptively be converted into annuities that make retirement payments each year for the life of the retiree (and spouse). However, BA holders could choose other options -- they could withdraw the assets from their BA accounts at retirement or leave the assets invested in the BA accounts until a later date.

IV. Improving Solvency

Starting in 2007, workers under 57 years of age will be permitted to allocate to BAs 2% of their FICA wages, up to \$3,000 per year (increased annually to reflect price inflation). If these workers contribute 2% less a year to the SS system, at retirement they must accept a reduced level of SS benefits than otherwise would be provided by the SS system. Therefore, if these reductions are calculated accurately, the BAs should be revenue neutral to the SS system over the century. However, critics can be expected to point out that the Federal Government would need to borrow monies to finance the transition from the current system to PIBA, since SS needs current FICA taxes to make current payments to retirees.

Although Federal Government borrowings would be needed to finance this transition, the SS system as currently structured would require borrowings with a present value of \$3.8 trillion in order to pay for scheduled benefits over the 75 years – the period used to measure the solvency of SS. In other words, the future obligations of SS as currently structured exceed its projected assets by a huge amount. If scheduled benefits for SS are to be maintained, this excess would have to be financed by Federal Government borrowings.

Thus, the primary test is whether the present value of the borrowings required by PIBA is higher or lower than \$3.8 trillion over the next 75 years. The answer, according to the Chief Actuary of SS, is that the present value of SS borrowings under PIBA is only \$1.9 trillion over the next 75 years (based on two-thirds of American workers participating in BAs). In short, we can cut the long-term deficit of SS in half by adopting PIBA.

Nevertheless, some commentators will urge Congress to adopt SS reforms that will eliminate the whole long-term deficit of SS over 75 years. But that goal is unrealistic and unnecessary. The economy of the US is large and growing steadily, so we can support some borrowings for SS benefits without jeopardizing the continuation of other

governmental programs. Instead, we need a substantial reduction in SS borrowings to a more reasonable level than the one required to maintain the current schedule of SS benefits.

A secondary set of tests for any SS reform proposal is whether the Federal Government borrowings required by such proposal would be completed within the 75-year period for measuring SS solvency, and whether the balances in the SS trust fund would be rising at the end of that period. In other words, does the proposal for SS reform leave the country in the position that the SS system would be self-financing after 75 years? According to the Chief Actuary of SS, all Federal Government borrowings required by the PIBA proposal would be completed by the mid-2070s before the end of the 75-year period, and the SS trust fund balances at the end of this period would be positive and rising.

Conclusions

PIBA effectively meets all the goals of both Republicans and Democrats, though each party would presumably want to add to, or subtract from, various parts of the proposal.

First, PIBA reduces by half the present value of the long-term deficit of the SS system from \$3.8 trillion to \$1.9 trillion. This should restore confidence in the SS system by American workers, especially those from younger generations.

Second, if PIBA is implemented, the SS system will be self-sustaining after 75 years. In other words, the borrowings required by PIBA would be completed before 2079, and at that time the balances in the SS trust fund would be gradually rising.

Third, PIBA preserves the traditional SS benefits of low-wage earners, who depend primarily on SS for retirement income. It also preserves scheduled benefits for all workers already receiving SS benefits as well as for all workers over the age of 55 in 2004.

Fourth, while PIBA does slow the growth of scheduled benefits for middle and higher earners, workers would be given the opportunity to earn back that difference by allocating 2% of FICA wages to BAs up to \$3,000 per year (increased annually to reflect price inflation).

Fifth, according to estimates by the Chief Actuary of SS, workers choosing to make such allocations are likely to make up most (and perhaps all) of that difference by investing such allocations in the BA. This is based on conservative estimate of the long-term returns for a BA of 4.9% per year after annual expenses of 30 basis points and annual inflation of 3% -- largely below the range of 35-year returns during the last half century at the same expense levels and inflation rates -- substantially below the range of 35-year real returns for the BA portfolio for every year since 1950.

Finally, PIBA can be implemented without changing in any manner the procedures by which employers now submit FICA taxes to the IRS. The administrative costs of PIBA, as operated by the trustees of the Federal thrift plan, would be quite low -- 30 basis points per year.

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Since the Baby Boomers begin to retire in 2011, it is critical that SS be reformed within the next few years. Once the Baby Boomers are in retirement, it will become virtually impossible to change their benefit payments. Under PIBA, workers would open BAs in 2007 and progressive indexing would start in 2012. Now is the time to begin Congressional consideration of PIBA.