

SHOULD WE RETIRE SOCIAL SECURITY? Grading the Reform

BY HENRY J. AARON AND ROBERT D. REISCHAUER

Most Americans understand that Social Security faces a long-term imbalance between the cost of benefits promised under current law and the program's projected income. They realize that the looming deficits arise from the coming retirement of the large baby boom cohort, the steady increase

in life expectancies, and the reduction in fertility rates, not from program mismanagement.

Nevertheless, many wonder whether Social Security, devised during the Great Depression, amidst double-digit unemployment, pervasive poverty, and the inability of all but a few to save for retirement, is suitable for today's vastly changed economic, social, and financial conditions.

Today, policymakers and the public face a bewildering array of proposals to reform or replace the nation's public pension system. Fortunately for the interested citizen, most proposals take one of three approaches to reform. Some replace the current public system with private accounts. Others supplement the current system with private accounts. Still others strengthen and modernize the current system. In what follows we evaluate several prominent plans from each of the three major reform approaches, as well as sketch out one of our own. All the plans would restore financial balance to the nation's basic retirement system.

Criteria for Reform

We evaluate each plan on four criteria: benefit ade-

quacy, protection against risk, administrative efficiency, and effect on national saving.

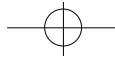
In our view a successful plan should, first, ensure adequate benefits that are equitably distributed to maintain protection for low earners and other vulnerable people. Current Social Security benefits are not unduly generous. Benefits of average earners who retire in the United States at age 65 are less than 1.5 times the U.S. poverty threshold. U.S. benefits replace significantly less of pre-retirement earnings than do public pension benefits in Europe. Large benefit cuts would leave retirees, the disabled, and survivors inadequately protected. At the same time, overall benefit increases are also undesirable because they would push costs, which will grow as baby boomers retire, to very high levels.

Second, the plan should spread broadly the unavoidable risks of long-term pension commitments, not place them on the shoulders of individual workers. Third, administrative costs should be low, and the plan should not be unduly complex for private businesses, workers, and the government. Finally, the plan should raise national saving by adding to reserves held in the Trust Fund or individual accounts (less any reductions in private saving or government surpluses outside of the retirement system).

Retiring Social Security

Two prominent plans would replace the current Social Security system with individual retirement accounts.

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The Personal Security Accounts Plan

The Personal Security Accounts (PSA) plan, advanced by five members of the 1994–96 Advisory Council on Social Security, would gradually replace Social Security with a two-tier system—a flat benefit based on years worked and the age at which benefits are first received and a benefit based on balances accumulated in mandated personal savings accounts. The flat benefit for workers and their spouses, as well as disability and survivor benefits that would be retained but scaled back, would be financed by a payroll tax of 6.2 percent for employers and 1.2 percent for employees; 5 percent of each worker's earnings, up to the maximum subject to the payroll tax, would go into his or her personal account. (The Social Security payroll tax is 12.4 percent of taxable wages—6.2 percent on the employer, 6.2 percent on the worker.)

The PSA plan would be phased in over many years. Retirees and workers over age 55 would remain under the Social Security system. Workers between 25 and 55 would receive a blend of benefits under the new and old systems. Workers under age 25 would receive benefits only under the new system. The new system would run a deficit for the first few decades, forcing the government to borrow some \$2 trillion (in 1998 dollars). Payroll tax rates would jump 1.52 percentage points—0.76 points for the employer, 0.76 points for the worker—for about seven decades to pay the interest costs and repay the principal on that borrowing. Eventually, as Social Security phases out, revenues would exceed costs and the debt would be paid off. When all borrowing had been repaid, the supplemental payroll tax could be repealed.

The PSA flat benefit would guarantee inflation-protected payments (of roughly 75 percent of the current Social Security benefit to low-wage workers) until the worker and his or her spouse died. The personal account benefit would not provide financial protection against inflation (or a long life) unless the worker chose to buy an inflation-indexed annuity with his or her personal account balance. All of the flat benefit, but none of the personal account benefit, would be subject to income tax, a change that would raise taxes on low- and moderate-income retirees and lower taxes on retirees with higher incomes.

Benefit adequacy and equity. The PSA plan promises good benefits for retirees on average but fails to protect certain vulnerable groups. For example, it cuts disability benefits (now provided by Social Security) as much as 30 percent.

Because workers would be able to invest their personal accounts in a wide range of assets, some would do well, but others would do poorly and suffer reduced benefits.

Protection against risk. The inflation-adjusted flat benefit would provide excellent protection against risk. Personal account returns would be risky, however, since they would depend on how funds were invested, what administrative fees were imposed by fund managers, how high asset values were when balances were withdrawn, and whether pensioners bought annuities when they retired.

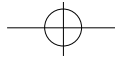
Administrative efficiency. The PSA plan does poorly on this criterion. The Social Security administrative structure would have to be maintained for many years, and two new systems would have to be set up: one to administer the flat benefit and another to see that employers made timely and accurate deposits into personal accounts and that the financial institutions managing personal accounts complied with the unavoidable regulations. The administrative burdens on small employers might be so onerous as to make the plan unworkable. Finally, dramatically higher administrative costs would lower net returns to workers, compared with plans that managed similar investments centrally.

National saving. The PSA plan adds to national saving by raising payroll taxes. But the personal accounts would be so similar to existing IRAs and 401(k) plans that workers might reduce other private saving or increase borrowing. Congress would also come under pressure to give workers access to their accounts—for medical emergencies, say, or college tuition—before retirement. Yielding to such pressure would diminish both the resources for retirement and any positive effect on national saving.

The Feldstein Plan

The second proposal to replace Social Security was crafted by Martin Feldstein, a Harvard economist and former chairman of the Council of Economic Advisers. Under his plan each worker would deposit 2 percent of earnings, up to the maximum subject to the payroll tax, in a personal retirement account. To offset the cost of these deposits, workers would receive an income tax credit financed by the projected federal budget surpluses. Once the surpluses ended, increased federal borrowing, tax increases, or spending cuts would be required.

The personal retirement accounts would be invested in regulated stock and bond funds chosen by the worker and administered by private fund managers. When workers began to draw pensions from



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their accounts, their Social Security benefits would be reduced by \$3 for every \$4 withdrawn. In effect, the benefits promised by the current Social Security program would become a floor under pensions. Overall, retirees would receive about 60 percent of their benefits from Social Security and 40 percent from personal accounts. Higher earners would depend more on their personal accounts; some would receive nothing from Social Security. The cuts in Social Security benefits would eventually close the projected long-term Social Security deficit.

Benefit adequacy and equity. By tapping into the projected federal budget surpluses, the Feldstein plan would be able to raise pensions—a feature we regard as imprudent in light of the sizable cost of pensions for retiring baby boomers. It would raise benefits more for high earners than low earners. A typical low earner, with average monthly earnings of \$1,000, would, at retirement, receive a Social Security pension of \$560 and an individual account pension of \$240. When Social Security benefits are reduced by three-quarters of the individual account pension, the low earner's total pension would be \$620, an increase of 11 percent over the current Social Security benefit. A high earner, with average monthly earnings of \$5,600, would receive a Social Security pension of \$1,375 and an individual account pension of \$1,340. The total pension, once Social Security benefits are reduced by three-quarters of the individual account pension, would be \$1,720, an increase of 25 percent. Because high earners are likely to select higher-yielding, albeit riskier, portfolios, their benefits are likely to increase even more.

Protection against risk. The Feldstein plan provides substantial protection against market risk because it guarantees a pension at least as large as that promised by the current benefit formula. But the plan is likely to undermine political support for a defined-benefit guarantee like Social Security among high and moderate earners, most of whose pensions would be based on their personal accounts. The plan also poses major fiscal risks because the commitment to increased pensions would generate severe budget pressures, particularly after currently projected surpluses end, that would affect all government spending and taxes.

Administrative efficiency. The Feldstein plan would be complex and costly to administer. Administrative and investment management fees will eat into returns on personal account balances. And the Social Security Administration would have to design and operate a system to make the three-quarter reductions in Social Security benefits based on withdrawals from personal accounts.

National saving. The effects of the Feldstein plan on national saving are complicated and unclear. Initially saving would not be affected at all, as the deposits in individual accounts would be funded by budget surpluses. The longer-run effect on saving depends on how successive Congresses and presidents react when the surpluses can no longer sustain the required individual account deposits, as well as on the extent to which workers cut back on other saving.

Reform Social Security

and Add Personal Accounts

Another group of proposals would supplement a reduced Social Security system with small defined-contribution personal retirement accounts.

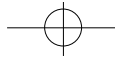
The Individual Account Plan

The Individual Account plan, proposed by Edward Gramlich, chairman of the 1994-96 Advisory Council on Social Security, would gradually cut Social Security benefits to allow the current 12.4 percent payroll tax to cover future program costs. Cuts would be small for low earners but up to more than 25 percent for high earners. A 1.6 percentage point increase in the employee payroll tax would finance small personal retirement accounts to be invested in a limited number of index mutual funds managed by a government agency. Balances would be converted into inflation-protected annuities at retirement.

The annuities would be small. A worker with median covered earnings who was 40 years old when the plan was implemented would receive, at age 65, monthly benefits of \$125 (in 1998 dollars), about 13 percent of expected Social Security benefit under the current system. Older workers would start contributing at a later age, contribute for fewer years, and receive less; younger workers would participate longer and receive larger pensions. Because payroll taxes would fully finance the new individual accounts, the plan would require no other transitional taxes or borrowing.

Benefit adequacy and equity. The Individual Account plan would continue to rely heavily on Social Security, although benefits would be cut significantly. On average, pensions financed by individual accounts would fill in this gap for people of retirement age. But disabled workers would suffer reduced benefits until they reached retirement age, and workers who became disabled when young would have little in their individual account even then.

Protection against risk. The individual accounts would be subject to market risk, but the risk would



be moderate because investments would be limited to a few centrally managed index funds. The pensions based on individual accounts would form a small portion of future retirees' pensions—about 30 percent for an average earner and 20 percent for a low earner. Both the scaled-back Social Security pension and the individual account pension would be inflation-protected annuities.

Administrative efficiency. Central administration and the limited number of indexed investments would hold down administrative costs. Nevertheless, these costs would be somewhat higher than those under Social Security because the federal government would have to deposit funds in accounts of each worker's choice, educate workers about the options, and respond to questions.

National saving. The increased payroll tax and the benefit cuts would both raise national saving. The centrally held individual accounts would probably add to saving because they would not be viewed as good substitutes for IRAs or 401(k) plans.

The Moynihan Plan

Senator Daniel Patrick Moynihan (D-NY) proposes to cut both payroll taxes and Social Security benefits and to authorize—but not require—workers to set up individual accounts. Retirement, survivors, and disability benefits would fall an average of about 20 percent. Payroll taxes would be cut 2 percentage points—1 point for workers and 1 point for employers—until 2025. Workers could spend their share or save it, either in personal accounts administered by a new government board or in special Individual Retirement Accounts managed by financial institutions of their choosing. Contributions of workers who chose to set up personal accounts would have to be matched by their employers. Withdrawal from the account at retirement would be unrestricted; it need not be in the form of an annuity.

From 2025 to 2060 the payroll tax rate would rise gradually to keep program revenues in line with benefit payments. In 2060 the payroll tax rate (by then 13.4 percent), together with contributions to personal accounts, would claim 15.4 percent of covered earnings, 3 percentage points above the current payroll rate. Over time the Moynihan plan would return Social Security to a pay-as-you-go system, with a contingency reserve sufficient to tide the system over a severe economic downturn.

Benefit adequacy and equity. This plan would steeply erode benefits and in ways that could hurt vulnerable groups the most. Because benefits would be reduced by holding the annual inflation adjustments 1 percentage point below the Consumer Price Index, those who received benefits the longest—the very old and the long-term disabled—

would suffer the largest cuts.

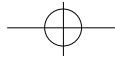
Protection against risk. Because workers could choose how to invest their voluntary accounts, they would be exposed to investment risk. Social Security would provide only partial protection against inflation; pensions derived from the voluntary accounts would offer none. With no restrictions on when or how to convert their account balances into retirement income, some retirees could outlive the pensions based on their personal accounts.

Administrative efficiency. Government administrative costs would rise. The Social Security Administration would be retained in full, and the government would have to manage a new individual account system and to ensure compliance for private plans. Businesses would have to keep track, pay period by pay period, of whether workers wanted to contribute to individual accounts; whether, for those who did, to deposit funds in the government system or in the private accounts; and, for those who chose the latter, which of many thousands of private fund managers the worker had selected.

National saving. Theoretically, because the plan would deny full inflation adjustments not only for Social Security benefits but also for the personal income tax and all indexed benefit programs except Supplemental Security Income, it would increase national saving. But in practice, Congress is not likely to permit income tax collections to rise over the years (the inevitable consequence of not indexing the tax brackets, exemptions, and the standard deduction) or the purchasing power of entitlement benefits to fall. Thus the plan would lower national saving.

The Breaux-Gregg Plan

The plan proposed by Senators John Breaux (D-LA) and Judd Gregg (R-NH) and others would divert 2 percentage points of the current payroll tax to individual accounts. To cover that cost and to close the projected long-term deficit, the plan would cut Social Security benefits an average of 25–30 percent. At retirement, a worker would be required to convert enough of his or her account balance into an inflation-proof annuity to ensure that the annuity, plus the reduced Social Security benefit, would meet a minimum retirement income standard. The balance of the individual account could be withdrawn as needed by the retiree. A minimum benefit would be established equal to 60 percent of the poverty threshold for those with 20 years of covered earnings, rising to 100 percent of the poverty threshold for those with 40 years of earnings. A fail-safe mechanism would automatically keep the program in long-term balance.



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Benefit adequacy and equity. The assured element of pension protection would be drastically curtailed under the Breaux-Gregg plan. Large Social Security benefit cuts are necessary because the plan would divert payroll taxes from Social Security into the individual accounts.

Protection against risk. The market risk of individual accounts would be moderate because investments would be limited to a few centrally managed index funds. The guaranteed minimum benefit would provide some protection to low earners if returns from their individual accounts turned out to be sub-par, though over time productivity growth will push up real incomes while the poverty threshold will increase only at the pace of inflation. If many low and moderate earners received pensions based on the guaranteed minimum rather than on the Social Security benefit formula, the fundamental relationship between contributions (based on earnings) and benefits would be weakened, and political support for the system could diminish. The mandatory annuitization of a portion of the individual accounts would provide protection against outliving one's pension.

Administrative efficiency. The central administration and investment management of the personal accounts would keep costs down. Complexity would arise with the need to calculate the portion of each personal account to be annuitized and to administer both the annuity and the remaining balance.

National saving. Because it does not raise payroll taxes, the plan would not add much in the near term to national saving. Individual accounts would tend to add to national saving because they would not be considered good substitutes for IRAs or 401(k) plans.

Retain and Reform Social Security

The final approach to reform preserves the current defined-benefit system, tying pensions exclusively to each worker's past earnings and years of work, not to fluctuating asset prices.

The Ball Plan

Robert M. Ball, a former commissioner of the Social Security Administration, would restore projected long-term balance by raising revenues and cutting benefits modestly, as well as by diversifying the assets held by the trust fund reserves. Roughly half the projected long-term deficit would be closed by investing a portion of trust fund reserves (up to 40 percent by 2015) in the stock market.

Benefit adequacy and equity. The Ball plan would provide larger benefits than any of the other plans described, save the Feldstein plan. Vulnerable groups would be well protected.

Protection against risk. Because this plan would rely exclusively on defined-benefit pensions, it would spare workers exposure to the risks inherent in individual accounts. Annual cost-of-living adjustments would protect against inflation. The weakness of the Ball plan is that it does not solve the Social Security fiscal imbalance for the long run. The modest changes it proposes would allow Social Security to fall out of close long-run actuarial balance. We think current public distrust of the retirement system and of government in general makes it vital to adopt reforms that will restore financial balance and sustain it.

Administrative efficiency. The Ball plan would maintain the current low-cost administrative structure for taxes and benefits. Small added costs of investing trust fund reserves in equities should amount to no more than 1/100 of 1 percent of funds invested.

National saving. Because the Ball plan would both cut benefits and raise taxes only modestly, it would have little effect on national saving.

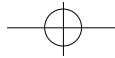
The Aaron-Reischauer Plan

Our own plan relies exclusively on a defined-benefit retirement system. It would cut benefits by about 8 percent on the average to boost reserve accumulation and raise national saving.

The plan's distinctive characteristic is the creation of a new Social Security Reserve Board, modeled on the Federal Reserve Board, that would manage all financial operations of Social Security. With multiple institutional safeguards in place to insulate the SSRB from political pressure, the board would invest Social Security reserves in excess of one and one-half year's benefits passively in a broad mix of private securities.

The operations of the SSRB would be removed from the budget presentations of the executive and legislative branches. Budget resolutions enacted each year to guide congressional action should exclude Social Security from aggregate totals.

Benefit adequacy and equity. Although our plan reduces benefits more than the Ball plan does, it does not cut pensions significantly for vulnerable groups such as the disabled. It would boost benefits for most surviving spouses. The new strategy for investing Trust Fund reserves would bring to people dependent on public pensions the higher yields made possible by a broad portfolio of public and private bonds and stocks.



Protection against risk. Our plan preserves the key advantage of defined-benefit pension plans by spreading risks broadly among the general population. Benefits would remain fully protected from inflation. The plan more than closes the long-term deficit, thus reducing uncertainty about future adjustment. It also incorporates a mechanism that would help to ensure that if the reformed program were ever to fall out of long-run actuarial balance, policymakers would enact corrective measures.

Administrative efficiency. Our plan maintains all the efficiencies of the current system.

National saving. Our plan would add moderately to national saving. It would isolate Social Security surpluses from the general budget process so that they are more likely than under the current budget rules to add up to national saving.

No Straight A Grades Here

No perfect way exists to reform the nation's mandatory retirement program. No plan, including our own, that cuts benefits or raises taxes merits a straight A grade. While investing Social Security's growing reserves, collectively or through individual accounts, in assets that have higher yields than government bonds can help, it cannot alone close the projected deficit. To finish the job, future retirees will have to accept smaller benefits than those promised under current law or future workers will have to pay higher taxes. The weightlifter's maxim, "no gain without pain" applies also to pension policy. The question is whose gain and whose pain? ■

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