How Should Social Security Be Reformed? A Panel Discussion

Political Aspects of Social Security Reform

Peter A. Diamond*

We have been asked to summarize what we have learned here at the conference and reach a consensus for policy recommendations—a great goal, but I know you will not be surprised to hear that I am going to disappoint you. Let me begin with a few questions. First of all, did Social Security reduce saving? My answer is, I hope so. As we heard from Edward Berkowitz, in the early days of the system, the whole point of speeding up the payoff was to give more consumption to the elderly. To do that, however, you had to have less saving. The purpose of the system then was to decrease saving.

It is difficult to criticize a program for successfully accomplishing what it was set up to do. But understanding this background to Social Security does not mean we cannot ask now whether it would be good to *increase* saving through the Social Security system. That is an independent question.

We have heard a number of references here to whether increasing the economy's saving should in itself be considered good. To answer this question, one must ask whose consumption would go down now as a result, and whose consumption would go up later. Reducing the consumption of the poor now to increase the consumption of the rich in the future is a very different policy from reducing the consumption of the rich now to increase the consumption of the poor later. (One does need to consider the interest rate in both these calculations, but it likely would be swamped by changes in the other factors.) It is important to recognize, thus, that questions about the effects of increased saving are ill-posed when they are put too generally.

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Almost all the discussion here has been about tax increases, that is, about partially funding Social Security. We have heard little discussion of the three alternative ways of managing the fund, which are the heart of the three plans from the Social Security Advisory Council. For shorthand, I will refer to them as the IRA plan or the personal security accounts plan, where almost any financial intermediary would do to administer investment choices; the 401(k) plan, Ned Gramlich's individual accounts plan, where the government would set up portfolios; and of course the maintain benefits plan, which would have direct investment of the trust funds.

Henning Bohn has pointed out that on economic grounds, defined-benefit investing in the stock market is preferable to defined-contribution investing, because the former has the advantage of risk-sharing over generations. That advantage is a fundamental difference between these ways of investing in the stock market.

If we focus instead on administrative costs, then investing the trust fund in the stock market beats either of the defined-contribution methods as well. For such administrative costs, the Advisory Council's estimate was one-half a basis point for investing the trust fund in the stock market (as in the maintain benefits approach), 10.5 basis points for the 401(k) approach, and 100 basis points for the IRA approach, although that estimate is controversial.

When considering these issues, it is interesting to look at some of the evidence from Britain. The British personal pension program takes an approach similar to the IRA plan, except that it is voluntary. Their average personal pension plan has a load of 8 percent, a charge of 90 basis points on assets, and a monthly fee of two and one-half pounds. Some of their pension funds recently have become much cheaper or offer index funds, and now appear quite similar to our mutual fund market. The spread in loads and administrative charges between individual funds is enormous, however. A relatively inexperienced British public is making its own investment decisions in this program, so one finds the plans all over the place in their patterns of risk and return.

Significant fixed costs are associated with this IRA-type approach to a pension system. As a result, the poor will end up with lower rates of return than the rich on what they save. This has been an issue in Chile, where over the first decade of their new IRA-type pension system they found almost a 5-percentage-point difference in the after-tax rate of return between the low earners and the top earners, because of the fixed portion of the charges.

So if a defined-benefit plan has been established as superior to a defined-contribution system both for maximizing risk-sharing and for minimizing administrative costs (and I would also argue that it is superior in its ability to provide insurance, given the difficulties in our individual annuity markets), what is the debate about? The answer is that the debate over Social Security reform is about politics, and not about economics. The economics are fairly clear, as Ned Gramlich has noted. Unfortunately, this conference did not devote a session to the politics of Social Security reform, so I fear one cannot move directly from the conference to policy conclusions.

How do politics influence the current debates? One way is through the issue of what would happen to the rest of the government budget if we raised the payroll tax to fund Social Security. I was surprised this point was not mentioned more here. Diane Macunovich made reference to the Social Security surpluses "financing the deficit" through the 1980s. The idea here is that the large deficits of the 1980s were enabled by accounting techniques that included Social Security surpluses on the income side, making the deficits appear smaller than they would have otherwise. This, in turn, made it easier for politicians and the public to let the deficits continue to grow, rather than cutting expenditures or raising taxes. I disagree with Macunovich's argument, however. In my view, decisions about the size of the budget deficit essentially were independent of the size of the surpluses being run by Social Security. The argument is that we had big deficits and the rate at which we reduced them was driven by the difficulty in cutting expenditures and the reluctance to raise taxes. And somebody would be saying the number is $250 billion rather than $190 billion. I just do not think that would have had a lot of effect on the budget decisions that happened.

Looking to the future, what kind of accounting changes might the government get into, to try to redefine the budget deficit? And what political implications would follow from that redefinition? Under existing rules, if the Social Security trust fund were to sell bonds in order to purchase equities, that would be considered an expenditure. The situation is similar to that of the federal government selling assets to reduce the measured deficit. This is Larry Kotlikoff's criticism of standard deficit measures. If large changes to Social Security are on the horizon, the Congress will change how we measure the deficit to something they can live with politically. It is not clear how such changes will play out, but clearly we have been assuming that any tax increase for Social Security will not show up in the rest of the government budget as increased consumption spending.

Having noted objections to the IRA-type plans, what are the main objections to the defined-benefit plans? Scott Pardee voiced the central objection, which is that politics may inappropriately influence the federal government's investment decisions. If the Social Security trust fund is invested directly by the government, as in the maintain benefits plan, such political influences are clearly a danger. These concerns hold almost as directly under the 401(k) plan but would not apply at all under the IRA plan, which gets the government out of the business of making investment decisions.

The IRA plan is loosely modeled on the federal employees' retirement system, which has double insulation— from politics to the investment decisions. The first layer of insulation is the Trustees, who have fiduciary responsibilities to the beneficiaries and are not permitted to focus on anything else. The second layer of insulation is the fact that these Trustees are only allowed to invest in index funds, thus precluding them from making substantive investment decisions. They do make choices between particular funds and indexes: Do we go with the S&P 500 or with the Wiltshire? But beyond that, they have little discretion to direct the system's funds.

Setting up a system with some of these safeguards does not guarantee insulation. The state of Florida, for example, just decided to move civil servants' pension funds out of tobacco companies, as it is suing those companies. This decision was made by a board of three elected government officials, not an independent board of trustees.

The issue to keep in mind is, what would the politicians like? Does a system with these safeguards provide them with a politically stable equilibrium? In my view, the answer to this question is "Yes." Politicians often like having their hands tied: "Sorry, I cannot do anything about that." And the investment of pension funds is definitely included in that category. Indeed, when the federal employees' pension system was set up, Congress made it clear they were interested only in a system in which they did not pick stocks. Moreover, corporate America would recognize that tobacco companies, for example, were just the thin edge of the wedge —that the stocks of many other companies potentially could be targeted by those making the investment decisions, and for a variety of political reasons. There are no guarantees, but it seems to me that all of corporate America would be backing that firewall against individual stock-picking, once it was up. It seems to me that the risk associated with such a firewall would be reasonable relative to the return, even if one considered nothing more than the administrative costs associated with each reform plan.

When thinking about these risks associated with politics, it is important to spell out the implications for the entire pension system. One cannot simply carve out the defined-contribution part and claim to have improved the risks there, without accounting for what has been done about the system as a whole. The personal security accounts (IRA) plan has a flat benefit, supplemented by the proceeds of individual accounts. The 401(k) plan relies mostly on a defined-benefit system, so one really must think about the entire system. When focusing on the financial implications of the system, it is the long-term budget that matters and that impinges on the system as a whole. I would argue that the division between defined-benefit and defined-contribution plans probably makes very little difference, by comparison.

Ned Gramlich asked earlier, should we worry whether defined-benefit and defined-contribution systems can coexist? Will we see the system unravel? I agree this is a major concern, for three reasons. The first, which Henning Bohn mentioned, is that for as long as we keep the present Social Security system, it must pay interest on the unfunded liability. Now where would that interest payment come from in the 401(k) or the IRA plans? In both cases, it would come from the defined-benefit portion of the system. Ned did not propose to put 1.6 percent of taxes towards the defined contribution, only to have 1.3 percent show up there with the rest going to pay the unfunded liability. One hundred percent of the taxes for the defined contributions show up in the defined-contribution part. But 100 percent of the taxes for the defined benefits do not show up in the defined-benefit part. Someone who did not understand the full complexities of Bohn's paper might conclude that a defined-contribution system would be superior to a defined-benefit system. But that would be a mistake.

The second reason for concern about the coexistence of defined-benefit and defined-contribution systems comes from what Douglas Bernheim calls wealth illusion. It is the flip side of the "pennies-a-day" sales strategy—for just pennies a day you can have this wonderful stereo system. Cognitive psychologists know that to ensure reasonable judgment when comparing two quantities, both must be measured in the same units. In the typical calculations used in debates about privatization, however, one frequently sees the *flow* of taxes or the *flow* of defined benefits compared to the *stock* of wealth an average individual would have in a defined contribution plan. But those are different units. And I think there is a tendency to believe that the stock is larger than the flow even when they are worth the same.

Anecdotal evidence to support this point comes from experience with pension windows. When an employer offers a pension window with a supplement to a defined-benefit flow, employees generally are not very interested. But when an employer offers a pension window with a lump sum payment, employees flock to it even if it is significantly less than the defined-benefit flow they found unattractive. So I am inclined to think that perception is the real issue here.

The third reason for concern about the coexistence of defined-benefit and defined-contribution systems is that the redistributive aspects of the current Social Security system might be undermined. The redistributive aspects of the current system operate through its defined-benefit provisions. Given a mixed system, the people who are most politically sensitive would be aware that they were not doing as well in the defined-benefit portion of the system and might not recognize or value its redistributive aspects, and they might push for changes to it. In sorting out the implications of any reform plan, one must pay attention to these political elements. This is true whether the concern is potential political interference in the capital markets or about preserving important aspects of the current system, such as its social insurance characteristics.

In conclusion, I would emphasize that the annuitization issue concerns me a great deal. As we all know, poverty among the elderly is concentrated among widows. If, in the future, we have a decline in annuitization or, as in the individual accounts plan, a choice in the mix between a survivor pension and a worker pension, how will this play out for widows? This will depend on the rate at which wealth stocks are run down, if they are taken as lump sums. It will also depend on the extent to which individuals are sensible investors or take risks and make bad investments. We should be concerned, therefore, about the income distribution implications of those reform plans that include no annuitization or survivor protection, which are an essential part of our current system.

Panel Discussion: It's High Time To Privatize

Laurence J. Kotlikoff *

I want to propose a solution to the Social Security crisis that addresses many of the concerns about privatization raised today by Peter Diamond and others. Let me begin by summarizing briefly the concerns.

One concern repeatedly voiced is what fees, loads, and other charges might be levied on defined-contribution accounts. A second is that reforming Social Security would eliminate the progressive benefits schedule and hurt the poor.

A third issue is that of intergenerational equity in funding. Some of the proposed reform plans involve issuing large amounts of debt. The question in such plans then becomes whether the debt would be paid off or end up as a burden that future generations would have to pay. Some of the plans out there really are ways of relabeling what we already are doing and do not effectively address the intergenerational equity issue.

A fourth concern is the protection of secondary earners. The current Social Security system has fairly substantial benefits for dependents. Consider a nonworking spouse staying at home caring for the children. How would he or she be protected under a privatized system?

A related issue, also mentioned by Peter Diamond, is that of annuitization. The current Social Security system pays its benefits in the form of annuities. But we know that the private annuity markets, both in the United States and in other countries, are quite imperfect because of problems of adverse selection. How do we deal with that in a privatized system? If individuals are not annuitized, they do not have insurance against life span uncertainty. If they do get annuitized, the bad risks may contaminate the market and make the pricing of annuities unfair.

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Keeping these concerns in mind, let me propose a solution to the Social Security problem conceived by Jeffrey Sachs and myself, which relies on a scheme to privatize Social Security. I will then outline how our plan, entitled the Personal Security System, addresses fundamental concerns that Peter Diamond and others have raised about privatizing Social Security.

Let me begin by pointing out what our proposal does not do. It does not touch the survivor insurance or disability insurance parts of Social Security. People will continue to contribute to these programs. Both the disability insurance and the survivor insurance taxes would continue to bring in sufficient contributions to pay for these benefits on a pay-as-you-go basis. So those programs would not be altered at all.

What would change is that the old age insurance contribution—the contribution to the retirement portion of Social Security—would go into private accounts called personal security accounts. Before going into one of these accounts, however, two things would happen to any contribution. First, if you were married, it would be divided 50-50; half would go into your account, and half into your spouse's account. If both spouses work, then the two contributions would be pooled, with half of that pool going into each person's account. Each spouse would automatically have an equal-sized account, thus protecting secondary earners. These reforms also would provide more divorce protection than is afforded by the current system, in which a marriage must last for a minimum of 10 years for one spouse to collect any dependent benefits from the other spouse's earnings record.

Second, before a contribution was put into one of these personal security accounts, the government would provide a matching contribution on a progressive basis. That is, low contributors would get a government match and high contributors, people who are contributing a lot because they are earning a lot, would get no government match. So the progressivity the government would like to introduce in the system would be clear—everyone could understand precisely how much redistribution within a generation was occurring.

The balances in these personal security accounts would be invested in various index funds approved by, though not managed by, the government. An example of such a fund might be a world index fund, in which individuals would invest in the entire world portfolio of stocks and bonds, on a market-weighted basis. Rules for diversification and regulation would ensure that everyone was in the market all the time. Even if individuals went from one investment company to another they could only purchase the same types of security. They would not be able to "time" the market, to sell at low prices and buy at high prices—this system of personal accounts would provide protection against that type of behavior. Hence individuals would be forced to invest for the long term.

When people reached age 65, their account balances would be jointly annuitized with those of all others who were 65. Each year the government would solicit bids from the insurance industry to annuitize the current cohort. The company offering the lowest fees and also meeting other obvious criteria would win the competition. We would thus have full annuitization, with single-life policies. They would be inflation-protected, so the insurance company would hedge its liabilities through the purchase of inflation-indexed bonds. Since Social Security's survivor benefits would still be available, elderly widows and widowers would receive these benefits as well as their Personal Security System annuities.

What about the existing Social Security system? How would we pay off its unfunded liability? That is, how would we pay benefits to current retirees as well as to current workers when they hit retirement? Current retirees would receive their full benefits unchanged. Current workers would receive their full accrued benefits, *calculated as of the time of the reform*, when they reached retirement age.

That is, only the earnings contributed to the Social Security system before the reform would be counted in their earnings record. But no one would accrue any further benefits under the old system, with this proposal. If I am 46 at the time of the reform, for example, my earnings record would show zeros after that age. So my accrued Social Security benefit under our proposal would be exactly the same benefit as I would receive under the current system were I to leave the country and go to the Fiji Islands at age 46 and return at age 62 and ask for my Social Security benefits.

This means that when my generation and other working generations reached retirement age we would receive less in Social Security retirement benefits than otherwise would be the case. And over time, aggregate Social Security retirement benefits owed to successive retirees would decline to zero. That is, with the passing of time, only zeros would be filled in for earnings for increasing numbers of workers, and for increasing shares of the total years counted in those workers' earnings records.

But how would we pay for those current and accrued Social Security retirement benefits during the 40- to 50-year transition period? We view the accrued liability of the old system as a collective obligation. Everyone needs to help pay it off, in order to protect future generations. They are being burdened with so many other obligations, given our current health care system and other government programs. We need to help future generations, and do it soon.

So our plan would pay off this obligation with a federal retail sales tax or a value-added tax. The former has some advantages over the latter because a sales tax is a more transparent way to tax consumption. On the other hand, a value-added tax might be more acceptable politically. Because Social Security benefits are indexed against inflation, individuals dependent on Social Security benefits would be insulated from any increase in the price level that might come from passing a federal retail sales tax. Because their benefits automatically would be adjusted, the poor elderly subsisting on Social Security (and roughly 40 percent do live primarily off Social Security) would be fully protected under this proposal.

Why should we use a consumption or value-added tax? It is very important that the current wealthy and middle-class elderly assist in paying off this unfunded liability. They are currently receiving enormous transfers that are growing in real terms, through the Social Security and Medicare programs. And, like everyone else in society, they need to help pay for the excesses of the past. Such a tax thus reinforces our plan's emphasis on generational equity. Over time, we would end up with a fully funded, privatized social security system that was intra- and intergenerationally equitable and could be operated at extremely low fees. If the plan had everyone contributing to a world index fund, the fees for managing it probably would be priced by the financial marketplace at 20 basis points or less. Currently, you can purchase an S&P 500 fund for 20 basis points. So the fee issue is really a red herring.

To summarize, under this plan you have low fees, generational equity, progressivity through matching contributions, a real funding mechanism, and protection of secondary earners as well as improved provisions for divorce and survivor insurance. If you get divorced, your account balance equals that of your former spouse. You have annuitization at age 65. And if you die before age 65, your account balance will go to your spouse or to your other designated beneficiaries.

Furthermore, the tax plan will also have some very important macroeconomic effects. You have a consumption tax that starts out at perhaps 8 to 10 percent, which would be paying not just for Social Security benefits but also for the government's matching contributions to the personal security accounts. Through time, that consumption tax would fall to 2 or 3 percent. This declining rate would give people a bigger incentive to save—to consume less in the present and more in the future. It would act like a negative capital income tax.

This plan also has some good efficiency properties. People would see that every dollar they contribute into their private accounts is closely linked to their future retirement income—another difference from the current system. Hence, we would have much better labor supply incentives under our plan.

Moreover, using this consumption tax to retire the unfunded Social Security liability would lead through time to higher national saving and a higher capital stock—our simulations suggest roughly 40 percent higher. These simulations also show a 14 percent higher long-run level of output per capita, a 10 percent higher long-run real wage, and a 20 percent lower long-run real interest rate.

In conclusion, I think that privatizing Social Security can be done in such a way as to deal with all the legitimate concerns of the naysayers. It can also make a real contribution to improving our economic well-being and that of our children.

Panel Discussion: Social Security: It Ain't Broken

Alicia H. Munnell*

This panel is supposed to pull together the threads of earlier sessions, define the trade-offs discussed, and offer guidelines for reform. As the President has been concentrating on enacting a balanced budget and has not yet turned his attention to Social Security reform, the Administration does not currently have a position on how financial balance should be restored to the program. In April, however, the Social Security Trustees submitted their report on the program's financial status, so we do have a clear idea of the magnitude of the problem.

The Trustees' Report shows clearly that the system is not fundamentally broken. That does not mean that the system should not change. If we think that current benefits are too high or too low, we can change them. If we would like to have some Social Security money invested in separate accounts, we can do that. If we want to change the way we index benefits, we can alter the procedures. Social Security is a flexible program that can adjust over time. But any modifications to the program should be made in the context of changing preferences or goals, not in response to a false perception that the system is going to fail. Along these lines, therefore, I would like to make five points about Social Security's financial future.

First, Social Security has enough money to pay 100 percent of promised benefits until 2029, when the trust fund is exhausted. Even after the trust fund is exhausted, revenues would continue to meet about three-fourths of program costs. Social Security is not about to disappear.

The Trustees annually publish projections of the system's revenues

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and outlays for the following 75 years. They produce three sets of projections corresponding to high-cost, low-cost, and intermediate sets of assumptions. I believe that the intermediate scenario is based on the most reasonable economic and demographic assumptions, so I will use them for discussion.

Probably you all are familiar with these numbers, but they are worth repeating. The intermediate projection shows that between now and the year 2012, the Social Security system will bring in more money than it pays out. That is, receipts from annual payroll taxes and from income taxation of Social Security benefits will exceed outlays.

Thereafter, the baby boom generation retires and costs rise. At the same time, growth in the labor force slows, reflecting the big decline in the fertility rate that occurred after 1960. This increase in the ratio of retirees to workers causes the expenditures of the system to rise above revenues.

In the relatively short run—from 2012 through 2018—the sum of tax receipts and the interest on trust fund assets will produce enough revenue to cover benefit payments. After that, if no action is taken, total income will fall short of benefit payments, but the shortfall can be covered by drawing down trust fund assets until the funds are exhausted in the year 2029.

People talk about this 2029 date as if the whole Social Security system implodes in that year and nothing is left. This is one of the great misconceptions in the current debate—and it simply is not correct. Even if no changes were made on the tax or the benefit side of the equation, current payroll taxes and benefit taxation would provide enough money to cover roughly 75 percent of benefits in the year 2040 and roughly 70 percent in the year 2075. Thus, even without further legislation, the Social Security system is not about to dry up.

So is there a problem? Yes, there is. When the surpluses in the early years are combined with the deficits in the later years, projected income falls short of projected benefit payments over the 75-year forecast period. In other words, the system faces a 75-year deficit. The key issue, however, is the magnitude of that deficit. This brings me to my second point:

Social Security is running a 75-year deficit, but the actions required to eliminate this shortfall are well within the bounds of previous changes to the program.

Under the intermediate assumptions, the 75-year deficit amounts to 2.23 percent of taxable payrolls. One way to think about this magnitude is in terms of the tax increase required to eliminate it. Let me be clear here that I am not advocating a tax increase but merely a thought experiment. If we decided to finance benefits for the next 75 years by raising taxes, today's combined employee-employer tax rate of 12.4 percent would have to be raised to 14.6 percent *immediately*. That would involve a 1.1 percentage point increase each for the employee and employer. No one proposes to meet the deficit with this method, but thinking of the solvency problem in this manner provides an easy way to gauge its size.

Is such a 2.23 percentage point tax increase large in historical perspective? It is large, but not unprecedented. Between 1980 and 1990, the combined employer-employee tax rate went from 10.16 percent to today's 12.4 percent—a roughly equivalent increase. Thus, the gap could be closed with a not unprecedented rise in the payroll tax.

Does that mean that all the burden of eliminating the deficit should be placed on raising taxes? Definitely not. As you well know, Social Security retirement and disability benefits are not the only items being financed by the payroll tax. The Medicare program is growing much more rapidly than GDP and will also be profoundly affected by the aging of the baby-boom generation. It is important, therefore, to think of the combined burden on future taxpayers when considering solutions to the 75-year deficit in the OASDI program. Nevertheless, the second point that I want to make is that the 75-year deficit is manageable. It is possible to eliminate the current deficit and to maintain the bulk of the current program.

This point deserves one caveat, because Social Security's long-run financing is somewhat more complicated than the scenario I just described. One could argue that the 75-year deficit understates the magnitude of the financial problem. Under current law, the Social Security tax rate is fixed while costs are rising, and this configuration produces surpluses now and large deficits in the future. As a result of this profile, each passing year adds another year with a large projected deficit. Assuming nothing else changes, this phenomenon would increase the 75-year deficit slightly each year, by 0.08 percent of taxable payrolls. In contrast to what was done in 1983, many commentators now argue that the system should not be left with a huge deficit in the 76th year. Therefore, a complete package of deficit closers probably would include some provisions for the out-years in addition to those required to eliminate the 75-year deficit. My third point is as follows:

The economic and demographic assumptions underlying the 75-year projection are reasonable. This has been reaffirmed most recently by a Technical Panel of the 1994-1996 Social Security Advisory Council.

Projecting costs for the next 75 years is necessarily an uncertain exercise. It is equivalent to having made estimates for today in 1922. We would have had no idea about the Great Depression, World War II, or a host of other demographic, economic, and social developments. Nevertheless, such long-range planning can be a prudent exercise. The usefulness of the exercise depends crucially, however, on the reasonableness of the underlying assumptions. While the actuaries' calculations involve numerous variables, two demographic assumptions and one economic relationship are key.

On the demographic side, the two issues are fertility and mortality. Fertility tells us how many people will be in the labor force paying taxes, and mortality tells us how many people will be receiving benefits and for how long.

Since 1800, the fertility rate has declined persistently in the United States. The only significant deviation from this trend was the post-World War II baby boom. At the end of the baby boom in 1964, the fertility rate resumed its decline until 1976, before rebounding slightly. Currently the average woman would be expected to have 2.0 children over her lifetime. Demographers agree almost unanimously that fertility rates will remain low. As a result, the 75-year projections for the Trustees' Report are based on the assumption that the fertility rate will trend down slightly to 1.9 percent.

The consensus is that mortality also will decrease. This is important because the longer people live, the more years benefits have to be paid after retirement. The question is how fast mortality will decrease. For the 75-year projections, the 1997 Trustees' Report shows significant gains in life expectancy at 65, rising roughly three years by the year 2075 (reaching 18.8 years for men and 22.3 years for women).

On the economic side, a key variable is the difference between the rate at which benefits increase—namely, increases in the Consumer Price Index (CPI)—and the rate at which tax revenues rise—namely, the growth in wages. This difference is called the real wage differential.

The assumption about the size of the real wage differential is often viewed as the most controversial in Social Security forecasting, as the actual value has varied dramatically over time. During the 20-year period before 1973, when productivity growth was high, the real wage differential averaged 2.2 percent. Since 1973, however, it has averaged 0.3 percent. The question is how much weight to put on recent years as compared with the pre-1973 period. The Trustees have split the difference and adopted an assumption of 0.9 percent. What if they are wrong? By how much would a real wage differential of 0.3 percent, rather than the assumed 0.9 percent, raise the 75-year deficit? Sensitivity analysis shows that such a miscalculation would increase the 75-year deficit by roughly 0.6 percent of taxable payroll. In other words, a relatively large error in this assumption, taken in isolation, would worsen long-term Social Security financing by a relatively modest amount during the next 75 years.

Of course, if a large number of assumptions all turn out to have been optimistic, or all pessimistic, their cumulative effect could be quite large. The Trustees' reports show the results of two extreme cases: a "high-cost" alternative in which all of the main assumptions are assumed to take pessimistic values, and a "low-cost" projection that assumes optimistic values. According to the 1997 Report, under the high-cost alternative, the 75-year balance is in deficit by 5.54 percent of taxable payroll, more than twice the 2.23 percent deficit under the intermediate assumptions. In contrast, the balance under the low-cost assumptions is a small surplus of 0.21 percent of taxable payroll.

These two projections give a sense of the level of uncertainty about the long-term projections. Nonetheless, a 1994-95 Technical Panel to the Quadrennial Advisory Council on Social Security evaluated each individual assumption and concluded that, "The 'intermediate' projection . . . for the OASDI program provide(s) a reasonable evaluation of the financial status. Although the Panel suggests that modifications be considered in various specific assumptions, the overall effect of those suggestions would not significantly change the financial status evaluation."

That is my personal view also. One can quibble with any particular economic or demographic assumption, but taken as a whole they provide a very reasonable picture of the future. My fourth point:

Even though deficits reemerged after the 1983 enactment of the Greenspan Commission recommendations, this is not likely to happen again. These deficits arose not so much from problems with the economic and demographic assumptions, which roughly offset one another, but rather from an upsurge in the disability caseload and technical problems.

Critics might argue that we have fixed Social Security before, and it did not stay fixed. Specifically, in 1983 Congress enacted legislation based on the recommendations of a commission chaired by Alan Greenspan. At that time, it was asserted that those recommendations were sufficient to keep the Social Security system solvent for 75 years, with positive trust fund balances through the year 2060. Only a year after Congress enacted the legislation, however, the Trustees began to project a small deficit. That deficit has grown more or less steadily since then, to its current level of 2.23 percent of taxable payrolls. How did this happen? And will new deficits emerge once again even if we "fix" the deficit this time?

Let us start by talking about factors that are *not*—on balance—responsible for the current deficit, namely, the economic and demographic assumptions. Most of the discussions of Social Security's financing problems are couched in terms of the demographic shifts that will occur as the baby boom generation ages. Indeed, as we remarked earlier, the numbers are impressive; today 3.3 workers support each retiree, by the year 2040 that number drops to 2.0, and it stabilizes at around 1.8 in the year 2070.

The problem with this story is that the projected decrease in the ratio of workers to retirees, frequently cited as the cause of the emerging deficit, is little changed from 1983. The decrease was fully incorporated in the revisions made to the program at that time. Since 1983, if anything, the demographic developments have been positive—at least from the program's perspective. Life expectancy assumptions have been lowered slightly, thereby reducing long-run costs. The positive impact on long-run costs from changing demographic assumptions was roughly offset, however, by changing economic assumptions. In particular, the Trustees lowered the assumed rate of real wage growth as it became clear that the productivity slowdown was here to stay. On balance, the economic and demographic changes have roughly offset one another.

Then you may ask, "Where did the deficit come from?" Three major factors caused long-term costs to increase. The first one, which accounts for about one-third of the problem, was discussed earlier. That is, as time passes, the 75-year valuation period ends in a later year, so that more of the higher-cost out-years are included in the projections. Including more deficit years raises the 75-year deficit. The second is that the disability caseload grew much faster than anticipated, primarily because of legislative, regulatory, and judicial action that made it easier for individuals to qualify for disability benefits. Rising disability costs account for another third of the problem.

The third source of the post-1983 deficit—accounting for the final third of the problem—involves changes in the methodology used to project the future. These changes are one-shot occurrences that are unlikely to happen again. For example, the large increase in the deficit between the 1993 and 1994 Trustees' Reports was due mainly to new data suggesting that workers have more years of covered employment than previously had been thought and therefore are entitled to higher projected benefits.

The question is, if all these factors went wrong after the 1983 legislation, won't the same thing happen again? My best judgment is no. The first factor—the fact that as time passes, years with large deficits replace years with surpluses in the 75-year picture—can be taken into account in any reform. With regard to the second and third factors, it is impossible to assess the likely direction, much less the magnitude, of any changes that the actuaries inevitably will make. Social Security actuaries will continue to incorporate improvements in data and methods, and one would hope that as experience piles up and methods are tested and retested, the need for major reassessment would decline. Finally, demographic and economic assumptions may have to be revised but, as I said earlier, these are very reasonable assumptions and are as likely to be revised in ways that reduce costs as increase them. In fact, it is easier to think of two revisions that would lower costs—improvements in the CPI and more immigration—than to think of factors that would raise costs. This brings me to my final point:

It is unhelpful to lump together Social Security and Medicare and characterize the problem as "out-of-control entitlement spending." This characterization does not lead to useful discussion, since Social Security spending is not out of control but rather quite predictable.

When thinking about solutions to Social Security, as I said earlier, it would be silly to ignore the fact that the aging of the population will also place increased demands on the Medicare program. But Social Security and Medicare are driven by very different forces, and combining the spending projections for these two programs muddies rather than clears the waters.

In some ways, the two programs could be described as similar. Both programs provide a defined benefit—the one cash, the other insurance for a package of medical services—to roughly the same population: the aged and disabled and their families. Neither the populations covered nor the benefits provided under either program have changed much in the last 15 years. Medicare presents a much greater challenge than Social Security, however, both in the magnitude of the projected deficit and in the complexity of the issues. Unlike Social Security reform, Medicare reform involves not just selecting among a list of plausible benefit options, but rather figuring out how to control the volume and intensity of utilization while ensuring the efficient delivery of quality health care in one component of a very complicated health care system.

In short, combining Social Security and Medicare is very unhelpful packaging, since—except for the aging of the population—the costs of the two programs are driven by different forces. The more that Social Security's OASDI program can be discussed separately from the health care issues, the more productive will be the dialogue.

Conclusion

Let me conclude with two facts. First, Social Security retirement and disability benefits now are equal to 4.7 percent of GDP. To hear critics talk, one would think that this fraction would triple or quadruple by the year 2075. According to the intermediate assumptions in the 1997 Trustees' Report, OASDI outlays will amount to only 6.8 percent of GDP in the year 2075. Social Security spending simply is not out of control. The program does face a 75-year deficit, however, that should be eliminated in order to restore confidence in it.

This leads to the second fact. The changes required to restore balance to the Social Security program are relatively modest and could be done within the structure of the current system, if action were taken today. If the problem is let slide, say until the year 2020, we will no longer have the option to make modest adjustments. In the year 2020, the magnitude of the deficit will require more radical revamping. But that is not true today. The 1997 Trustees' Report, based on very reasonable economic and demographic assumptions, shows a program in need of modest repair —not one fundamentally broken.

PANEL DISCUSSION: PLANS FOR A COMPREHENSIVE REFORM PACKAGE

C. Eugene Steuerle*

Occasionally I have a dream where I attend or testify before a congressional committee such as the Senate Finance Committee. In this dream, I am watching the committee in action when suddenly someone runs in and shouts, "Eureka! We have found a cure for cancer!" And everyone in the gallery starts cheering. Then I look up at the committee members behind the podium and they all appear nervous and are wiping their brows. And suddenly I realize what the members are thinking: "Oh my gosh, this expensive cure means people are going to live longer. Social Security will go bankrupt, Medicare costs will skyrocket, and the budget will go bust. In short, the whole world will fall apart . . . ."

In some ways, my dream illustrates fairly accurately our broader budgetary debate with respect to Social Security. We discuss Social Security as a general policy issue, but the problems it causes in the budget are unique. Certainly in other areas where the social problems seem to be worsening, such as in our central cities, in education, or crime, we look for additional resources in the budget to try to tackle them.

But the problems associated with retirement and Social Security are improving, yet we continue to allocate increasing resources to them. We have a strange upside-down budget, not just in the United States but throughout the industrialized world, where we devote increasing shares to our least serious problems.

If one focuses on the four major sources of growth with respect to programs for the elderly, three of them are potentially under our control. But at present our spending on them is on automatic pilot. The first of these sources is the growth in real annual benefits. From its inception,

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Social Security has had wage indexing, which causes this growth in annual real benefits. Wage indexing might appear to be a reasonable structure for a pension plan. I would argue, however, that it is not necessarily a reasonable structure for an unfunded system. One could make an equivalent argument that we should have real growth in educational expenditures or in other areas valued by us as a society, particularly those that are unfunded. But then everything would have automatic growth built in.

The second source of growth is the increase in years spent in retirement. Those of us who spin the numbers know that had we indexed Social Security for longevity when it started, we would not be sitting here having this conference. We might be debating whether Social Security should be funded or not, similar to the 1930s debate. But we would not be focused on its large fiscal problem.

A third source of growth is the way we design health insurance. Health insurance is indexed to grow even faster than wages, mainly because health is an income-elastic good and our system is organized in such a way that we provide every service we possibly can as a society. This creates all sorts of incentives for cost-increasing technology and other potential distortions, and over time it leads to higher and higher costs.

The fourth source of growth, not as easily controlled, is our declining fertility rate. Regardless of where we set the retirement age or how we measure who is old, at some point we are going to have a higher percentage of the population who are truly old and have greater needs. To the extent that our government responds to the greater needs of its society, it will have to respond to this problem.

Three of these four sources of growth, then, are really within our influence. And in my view, a significant part of any solution to the Social Security budget problem should come from bringing these three sources under control. The fourth source of growth is not as easily manipulated: A higher percentage of our population *is* going to be truly elderly, and we will have to adjust the system to meet their needs. The bottom line, however, is that whether we fund or do not fund the system is an important issue, but it is not crucial to fixing the system budgetarily. One of my concerns, as this debate circulates among the public and through Washington, is the constant attention given to this funding problem to the exclusion of other issues.

One can make a related argument with some simple mathematics that the saving issue is the same sort of problem, important but often misplaced. The current system is premised on a future tax rate of roughly 33 percent for Social Security, Medicare, and other programs for the elderly together, relative to its current rate of 15 percent. That is not far from the Congressional Budget Office's projection of an increase in cost equal to roughly 9 percent of GDP. The Social Security tax base is roughly half of GDP; multiply by two and you have got an 18-percentage-point tax rate increase.

So the big saving and growth issue, in my view, is how to prevent the tax rate from going from 15 percent to 33 percent. That is, can we drop the promise to current generations from 33 percent back to roughly 15 percent? Whether we drop it further, from 15 percent to 10 percent, by shifting money into private savings accounts, is also important but, at least by this accounting, of a smaller order of magnitude.

One other related problem is how these cost increases add up. Under current law, a couple with average income who retire today receive promises of about one-half million dollars (in 1993 dollars) of Social Security and Medicare benefits, roughly half from each program. The Medicare portion of course is driven by projections of huge cost increases.

These numbers do not decrease. As one moves towards the future, the promised lifetime benefits rise to $800,000 in real dollars for an average-income couple. It is not pure rhetoric to claim that Social Security and Medicare promise some people they will be millionaires in the future, because higher-income people receive a higher level of Social Security benefits and those with longer life expectancies receive ever more Medicare benefits. Our system is providing tremendous resources to us in our elder years. In my view, these benefits are also large relative to what we promised ourselves or our children in younger years. The question of whether we are abandoning our young is intertwined with the question of just how much we want to spend on ourselves as we age.

Can we solve this problem by altering saving behavior and building physical capital? The main distortions in the present system are on the human capital side and not on the physical capital side. Now as public finance economists, we are very well-trained to examine saving and investment issues. I am reminded of Bob Solow's quip in his famous debate with Milton Friedman. Solow said that while everything reminded Milton of the money supply, everything reminded him of sex, but he kept it out of the conversation. As public finance economists, when we debate these issues, everything reminds us of how we can manipulate saving and investment to solve our problem.

One big distortion in the current system is that we have let it determine expectations, rather than use it to respond to our greatest needs. It tells us to retire for one-third of our adult lives and allocate our consumption in distinct ways between cash and Medicare benefits, creating a dependence on the government irrespective of the relative needs of society and the use it could make of our productive capabilities. A number of distortions on the human capital side appear to dominate the issue of what happens to physical capital. You cannot build enough steel mills to solve the Social Security problem.

Only a couple of the papers presented here have discussed human capital. Even the one focused on labor supply issues addressed mainly how changes in rules for financial markets, saving, and Social Security would affect labor markets—as opposed to the more direct issue of what is happening to labor markets now because of the design of the systems themselves. Several people even argued that we as economists can do nothing. People are retiring earlier and earlier and it is a natural phenomenon.

I would argue that over the past 50 to 60 years, we have spent tremendous increments of our wealth as a society on more leisure and more health care in retirement, at a rate much faster than the growth of GDP. In the process, we have built up tremendous institutional barriers to remaining in the work force beyond a certain age. The intertwined nature of these barriers is one reason our econometrics are so weak at estimating whether we can solve the problem by changing any one individual policy, for example, by removing the earnings test.

What are these institutional barriers? One is growing Social Security wealth. A second is Medicare wealth, which is growing even faster than Social Security wealth. Such generous benefits certainly create a wealth effect, causing people to retire early. Furthermore, the signals government sends out by setting the retirement age can have a powerful socialization effect. Telling people 65, or even 62, is the retirement age is a powerful signal.

Social Security heavily subsidizes early retirement despite the assumption that the systems are actuarially fair to those who continue to work, or at least one day will be fair when we get full delayed retirement credit. That assumption is incorrect, as it compares potential benefits at different retirement ages, but fails to account for taxes. Workers pay in at least 30 percent of their wages to government as taxes, while retirees do not. Even if it were actuarially fair, the earnings test would still be interpreted as a signal to retire. We also have a very powerful health care earnings test—the requirement that Medicare be a secondary payer, which poses a huge cost to employers who must pay for the health costs of older workers. Like the government, for reasons I will not go into here, the private sector has also built up institutional barriers to work over the past few decades and encourages early retirement. We must start to move in the opposite direction and remove these barriers, one by one.

What principles should then apply to Social Security reform? Our focus today has been mainly on two somewhat opposing principles—the social adequacy of Social Security versus its efficiency and individual equity. But I would argue that we need to return to even more fundamental principles. We must ask ourselves what we are trying to do with this system in the first place. There is such a thing as target efficiency, even for a program whose primary goal is equity. For example, if we want to keep the elderly out of poverty, let us be target-efficient about it in ways that reduce the cost of the system and thus bring efficiency gains. When one looks at Social Security in this light, a number of budgetary principles emerge, among them that provisions for automatic growth of benefits take ownership of the budget away from current generations. They are prevented from spending to meet their greatest needs because of the automatic growth in these systems. Automatic growth provisions also create an unlevel playing field in deciding among various expenditures.

So what type of reform package makes the most sense? A principal goal should be to increase the retirement age. I take a stronger stand on this than most. We should agree upon a promised number of years of retirement such as 15, 16, or 17, and then hold it steady. That is, it should be a fixed index. We should stop promising ourselves larger percentages of life or ever more years in retirement. If, on a discretionary basis, we decide individuals should have more years of retirement, fine. We can then explicitly debate spending on Social Security *versus* education *versus* everything else. But we should no longer automatically increase the promised number of years of retirement as our life expectancy increases. Today, the system promises people retirement at 62, which provides about 17 years of retirement to a male and about 20 years to a female. For the longer-living of the two, the actuarial pension actually lasts about 25 years already. I think that is an excessive amount. I certainly would not let it grow and in fact I would reduce it slightly, to deal with the demographic problem that is approaching.

Along the lines of the Gramlich proposal, I would reduce the indexing of benefits. The exact ratio by which I would achieve this depends on several factors. I probably would be less harsh at the bottom—and would allow for some indexing of wages for a minimum benefit provision. But in essence, I would significantly reduce this other major source of growth of Social Security.

Then I would focus on what the system is trying to do—for example, reduce poverty among the elderly. The U.S. system has performed poorly compared to other countries' systems in moving the elderly out of poverty. One would think that such an expensive system, spending so much money, should easily accomplish this aim. In fact we have done a fairly mediocre job. But this would be an easy problem to solve—along the way, we could also resolve many of the redistributive issues that emerge when cutting back on benefits. It is fairly easy to take care of those at the bottom, and some real efficiency gains could thus be had at very small cost.

I would also include all contributions to Social Security in the benefit calculation. In the benefit formula, a final bracket gets a small rate of return, which supposedly is how we introduce progressivity into the system. But in fact, most contributions at the margin get nothing. So a very rich person who begins work late or retires early can actually get this marginal return from the last bracket while someone who works for more than 35 years often will get nothing for working the 36th year. Many two-earner couples, because of the design of spousal benefits, get nothing in return for the added taxes they pay in. These benefit calculations can be reconfigured to get substantial reductions in the net marginal tax rate (tax less benefit) for Social Security without necessarily affecting the distribution, as long as one compensates a bit in the progressivity of the benefit formula. And a number of potential efficiency gains like this are available.

On the tax side, Social Security actuaries project the tax base will continue to erode because of fringe benefits, mainly health and private pension benefits. I would not necessarily reduce the exclusion for many private pension benefits. On the health benefit side, however, a cap on the tax excludability of health benefits would mean all sorts of nice efficiency gains throughout the system. It would also help bring about a better, fairer tax system.

As already noted, we should create greater equity among couples and among caretakers. That is, secondary earners are treated badly in the current system. Those who have two earners in the family get substantially fewer benefits or pay substantially more taxes than a single-earner couple who pay exactly the same amount into the system. So there are great inequities here. I would move the system towards earnings sharing and counting at least some marginal return for each contribution to Social Security. To deal partially with the problem of unacceptably high poverty rates among widows, I would make some actuarial reductions for couples so they receive a lower initial benefit, in exchange for a higher benefit when they are very old—again, to be target efficient.

The Social Security program should be aimed at the old old—that is where the needs are. The near-elderly in their sixties are not the people to whom we should be directing more and more benefits. The process of having the system give us increasing years of retirement results in more benefits to those who have the least need of them. The system, thus, is increasingly target *in*efficient, because payments increasingly are going to people who are further from death and the conditions likely to surround death, such as disability.

What would I abolish from the current system? I would abolish the earnings test, because it is a bad signal to society. I also would abolish what I call the health earnings test, that is, Medicare being the secondary payer, because it pushes employers with health plans to remove elderly workers from their payrolls.

Let me conclude by stating my position with respect to the funding issue. I am sympathetic to having more funding in Social Security. My reasons are conservative relative to those who are promising large increases in economic growth if there is more funding. I think that more funding results in a better budget mechanism, since the government then recognizes its liabilities as it incurs them. In a system that must provide some minimum level of benefit to so many people, I believe that there is not much one can do to reduce the current tax rate. This consideration essentially drove the Gramlich calculation. Having decided upon providing a minimum benefit, not much leeway remains in a system collecting only 10.4 percent for OASI, particularly if individuals retire for one-third of their lives, and the demographic changes continue to move us toward two workers or less for every Social Security beneficiary.

In effect, I would move in the direction of funding, but primarily because it would establish the right budget rules. In the budget context, the increased funding would count as a liability on a current basis, which would tend to raise the measure of the current deficit. This would, in turn, put pressure on Congress to cut spending elsewhere. Can you get very far, however, by putting only 2 or 3 percentage points of a tax rate into an account, whether you do it à la Gramlich or à la the Committee for Economic Development? Some proposals add such accounts to the current system, others try to take a bit away from the system. Currently, I am trying to better integrate improvements in the private pension system to such an analysis. By itself, the private pension system does not cover roughly half of all workers well by retirement and does not provide much in the way of portable benefits. Technically, the benefits are portable. But if you look at the defined-benefit side of the equation, they are not indexed for those leaving work early. And so essentially, if one leaves a defined-benefit plan before age 50, one receives very little, regardless of how generous the system looks to those who work to retirement age.

I would like us to consider ways to increase the subsidy for private pension plans, but grant it only where the plans create some minimum degree of portability. For example, one could introduce a guarantee of 8 percent of wages growing at the rate paid on government bonds over one's lifetime as the minimum portable benefit a worker would get when leaving a private plan. The government could provide a couple of percentage points to help do this. Thus, in recent months, I have been looking at alternative ways to take the small amount of money people are talking about putting into a mandated plan and perhaps use it to subsidize the private system, if it appears mandates are unacceptable. To deal with the fact that some people are not going to fall into even an improved voluntary system, the minimum benefit of Social Security could be beefed up even more to ensure some sort of social adequacy.

In sum, Social Security reform must be considered in a comprehensive manner, and a whole package of provisions is required to make it effective in meeting its basic purposes.