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Criteria for Social Security Reform

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## **Criteria for Social Security Reform<sup>1</sup>**

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## ABSTRACT

Because currently anticipated Social Security revenues are inadequate to pay for promised benefits, reform of the Social Security program is likely. Several different plans to restore the program to actuarial balance have emerged, and more will arise as the debate continues. Comparison and evaluation of these alternatives require a framework for analysis and criteria along which to judge their strengths and weaknesses. After discussing the goals of the Social Security system, we identify three main criteria (income adequacy, individual equity and economic growth), and propose several other issues for consideration.

Analysts of Social Security finances generally agree on the following three points. 1) The age distribution of the American population is changing dramatically. The nation is aging. Over the next 35 years, the number of Americans aged 65 or older is likely to double, while the proportion of the population aged 65 or older is projected to increase by half -- from 13 percent to nearly 20 percent. According to the intermediate estimates of the Social Security Board of Trustees (1997: 22), the ratio of Social Security contributors to beneficiaries, already down from 5 to 1 in 1960 to 3.3 to 1 today, will decline further, to about 2 to 1 by the year 2030, and then drift slowly down to 1.8 to 1 between 2045 and 2075.

2) As a result of this demographic shift and other factors, such as the decline in the growth rate of real wages, the current Social Security tax and benefit rules are inconsistent. Under the intermediate assumptions of the Social Security Trustees, the revenues anticipated will be inadequate to finance the benefits promised. There is a long-range unfunded liability, which the Trustees estimate to average about 2.2 percent of taxable earnings over the next 75 years, or about 15 percent of the benefit stream. If no changes are made, the Old-Age, Survivors, and Disability Insurance Trust Fund reserves, which are currently increasing rapidly, are projected to be depleted by the year 2029. At that time, the Social Security system would not be able to meet its current obligations in full, although it would still have anticipated revenues equal to about three-quarters of anticipated expenditures.

3) Because of this long-range funding deficit, Social Security reform is inevitable. Some combination of increased revenues and decreased or delayed benefits is necessary. It is not a matter of if reform will occur, but rather of when and how it will occur.

There is debate on the appropriate timing of reform legislation and implementation. Some argue that there is no need to legislate reform today, both because the long-range liability is based on a 75-year forecast and because, even if this forecast turns out to be accurate, the trust funds would not be depleted for over three decades. Seventy-five years ago was 1922. Even economists, usually willing to predict anything, anytime, anywhere, would have been hard pressed to forecast the last 75 years accurately. Why institute reform (especially radical reform) to solve a problem that may turn out to be considerably less serious than it appears to be today?<sup>2</sup> And even if the problem remains, will not future generations, with more and better information than we have today, be in a better position to decide on the best alternatives? Others suggest, however, that there should be a significant lag between legislation and implementation, to allow citizens to adjust to the new environment on the horizon, and that whatever reform changes are introduced can be smaller the sooner they are implemented. Both of these points argue for prompt action.

Whatever the timing, there are many ways that revenues can be raised or future benefits curtailed. The 1994-96 Advisory Council's Technical Panel on Trends and Issues in Retirement Savings (1997: 71-87) outlined, discussed and evaluated a number of them. Future benefits could be lowered by raising the normal retirement age (which is nearly equivalent to an across-the-board benefit cut), adjusting benefits at less than the cost-of-living, means-testing benefits or by changing the initial benefit calculation formula. Additional revenues could be generated by raising the payroll tax rate, raising the earnings limit on which these taxes apply, expanding the definition of taxable income (to include the value of some employee benefits), subjecting more Social Security benefits to federal income taxation, adding general revenues to the system, including all new state and local government employees in the program, or investing some the trust fund reserves in equities.

The 1994-96 Advisory Council on Social Security (1997) has provided a framework for debate on these issues by presenting three very different visions of Social Security's future, each of which addresses the long-range deficit.<sup>3</sup> The Maintenance of Benefits (MB) plan preserves the current structure of the Social Security system, and relies primarily on revenue increases (as has often been done in the past) to finance the benefits that have been promised. The Individual Accounts (IA) proposal also maintains the basic structure of the Social Security program, but relies more on benefit decreases to balance future finances. The IA plan also adds a new and very controversial element -- mandatory, defined-contribution, individual retirement accounts over which individuals would have some management discretion. The third option, the Personal Security Accounts (PSA) plan, also mandates individual savings accounts (but larger ones than in the IA proposal), and proposes fundamental changes in the basic structure of the Social Security system. The PSA plan would replace traditional earnings-related Social Security benefits with a two-tiered system -- a lower tier, flat-rate benefit, independent of earnings, and an upper tier, defined-contribution, mandatory savings account, over which individuals would have considerable management discretion, both during the accumulation and the distribution of the assets.

How does one choose among these or any other Social Security reform proposals? Rational discussion of alternatives requires a framework for analysis -- a set of criteria against which the proposals can be compared. The purpose of this paper is to present and discuss a range of such criteria.

### **The Roles and Goals of the Social Security Program**

The criteria used to evaluate the Social Security program or proposed changes in it depend on its goals. The over-arching goal is a straightforward one -- to improve the economic security of current and future recipients, primarily retirees, but also survivors and the disabled. The debate concerns how best to do this.

**The importance of Social Security income.** Social Security benefits are the most important of four principal income sources upon which older Americans rely. In 1994, 91

percent of all household units aged 65 or older received Social Security benefits, and this one source provided 42 percent of their total cash income (see table 1 or figure 1). Three other

---Table 1 and Figure 1 about here---

sources each provided about one-fifth of the aggregate income: employer pensions (19 percent), earnings (18 percent) and asset income, primarily interest and dividends (18 percent).<sup>4</sup> Two-thirds of all older household unit received some asset income, but many had only small amounts. About 40 percent of these households received pension income, and about one-fifth had at least some earnings (Grad 1996: table I.1).

The aggregate importance of Social Security benefits differs dramatically by the age and income status of the recipient. The Social Security share of total income increases monotonically from 31 percent for those aged 65 to 69 to 56 percent for those aged 80 or older (see table 1 or figure 2 ). Earnings drop dramatically over the same age range, from about a third of total

---Figure 2 about here---

income (at ages 65-69) to less than 5 percent (at ages 80 and older). The shares from asset income and from employer pension benefits are more stable over the age range.

Among the poorest two quintiles of Americans aged 65 and over, Social Security benefits provided 81 percent of all cash income in 1994 (see table 1 or figure 3). For the lowest quintile, public assistance provided another 11 percent, leaving only 8 percent from all other sources.

---Figure 3 about here---

Those with earnings or pension benefits are rarely found among the lowest quintile. Among those in the highest quintile, in contrast, Social Security benefits provided less than a quarter of aggregate income in 1994. Earnings (29 percent) was the most important source in this quintile, followed by asset income (24 percent), Social Security benefits (23 percent) and employer pension benefits (21 percent).

The importance of Social Security benefits has been increasing, although not steadily, over time. In 1962, Social Security benefits provided only 31 percent of aggregate income for older Americans (Grad 1997). After the large increases in real Social Security benefits in the late

1960s and early 1970s, the share increased and then remained stable -- in the 36 to 39 percent range between 1976 and 1990. Since 1990, the share has increased again, from 36 (1990) to 40 (1992) to 42 percent (1994).

The message here is that Social Security benefits are a very important component of the financial well-being of most older Americans, especially the poor and the very old. At the same time, however, other sources provide nearly 60 percent of the aggregate income of those 65 and older, and closer to 80 percent for those in the top quintile. Thorough analysis must include not only the direct effects of reform on Social Security benefits, but also any indirect impacts that reform proposals might have on these other important sources of income -- earnings, pensions and income from accumulated savings.

**The goals of Social Security.** The Social Security system is a complex institution that plays many roles simultaneously. In some ways, it behaves like a (mandatory) savings program, like a savings account or a pension. Like these other instruments, it reallocates income over time, taking contributions during one's working years and then paying benefits during retirement. It is also an insurance program, like fire or automobile insurance, since it replaces some of the income lost following the disability or death of a covered worker, and thereby cushions the household's decline in economic well-being. Finally, the Social Security system is a very important income redistribution program, like the federal income tax and transfer system. Its progressive benefit structure transfers income from high-earning to low-earning participants, both within and between generations. Of all the federal transfer programs, it is the only one that explicitly bases the transfer on a life-time measure of economic status -- average monthly earnings over the majority of an individual's working life.

These multiple roles create multiple goals. The insurance and income redistribution roles suggest that income adequacy should be a concern. Are benefits sufficient for recipients to maintain some minimum standard of living? The savings aspect, on the other hand, suggests individual equity as an appropriate criterion. What is the relationship between what an individual

contributes to the system and what that individual can expect to receive in return? What is the rate of return? Is it a good investment?

Finally, the magnitude of the Social Security system suggests that it could have important macroeconomic effects. It might affect the economic decisions of individuals, firms and the government, and therefore influence the economic growth of the economy. Since future retirees will not be consuming Social Security checks or trust fund reserves (which are just pieces of paper and electronic entries), but rather the goods and services actually being produced during their retirement, the productive capacity of the economy in the future will be a key determinant of the economic well-being of workers and retirees alike.

In the discussion below, the evaluation criteria are divided into four categories: income adequacy, individual equity, economic growth and other considerations. The starting point is the set of criteria proposed by the 1994-96 Advisory Council's Technical Panel on Trends and Issues in Retirement Savings (1997: 63-65).

### **Evaluation Criteria**

**Income Adequacy.** The U.S. Social Security system grew out of the experiences of the Great Depression in which unemployment and old-age poverty were widespread. Legislative leaders became convinced that the nation was best served by the introduction of a national old-age retirement program based on the principles of social insurance.<sup>5</sup> A primary goal was to assist in the provision of income security in retirement, without the stigma of a public assistance or welfare system.

Social insurance usually has a number of characteristics (Thompson and Upp, 1997). It is mandatory for certain categories of individuals (e.g., workers), sponsored, regulated and in some cases managed by the government, and is financed by contributions from the eventual beneficiaries (or their family members). The contributions determine eligibility and sometimes the benefits levels, which are set by law. These characteristics allow the system to avoid the adverse selection problems of private insurance (i.e., the poorer risks are more likely to want the

insurance coverage), and permit explicit income redistribution between or within cohorts of participants, which is difficult to do in a voluntary system.

Without Social Security benefits, many older Americans would enter their retirement years with inadequate income. Some have lived in or near poverty all their lives, have had irregular work histories without pension coverage, and have been unable to save on their own. Others have been myopic, and have either refused to consider the savings needed to support consumption in retirement or miscalculating what would be required. Others may have had bad luck, hampered by limited personal endowments or by being in a profession whose skills become obsolete or in an industry or a geographic location doomed to economic decline. Social insurance is designed to dampen the economic implications of any of these unfortunate circumstances.

Through 1950, Social Security was less important than means-tested old-age assistance, measured by either the number of recipients or the total benefits distributed (Berkowitz 1997: 28). Amendments in 1950, however, increased the Social Security program's coverage and benefit levels, as well as the tax rates and the taxable earnings base. Since then, it has been much more important than public assistance in supporting the elderly. Disability benefits were added in 1956. The program continued to expand during the 1960s and 1970s, and is now the first line of defense against economic distress among insured older Americans.

Although Social Security benefits were never designed to be the sole source of support for older Americans, income adequacy remains the primary and most important criterion by which to judge the success of the program. Income adequacy should be considered with respect to retirement, survivors and disability income.

Income adequacy can be measured in at least two ways, relative to one's prior income (for example, a replacement rate) or relative to some absolute measure of need, like the U.S. poverty threshold. One of the program's greatest accomplishments has been the dramatic reduction in elderly poverty, from about 30 percent (and twice the national average) in 1967, to half that rate only 7 years later, following large increases in real Social Security benefits

beginning in early 1968. This decline occurred during a time when Americans were retiring earlier and earlier, making the progress all the more remarkable. Since 1982, the elderly poverty rate has been slightly below that of the entire population.

Neither replacement rates nor poverty indices are perfect measures of income adequacy. A replacement rate is static in nature. It compares retirement income in the first year of retirement to earnings the year before, and ignores changes in income flows thereafter. Depending on whether income flows (such as employer pension benefits) are indexed to changes in the cost-of-living, the same initial replacement rate could be associated with very different levels of economic well-being later on.

The American poverty concept is an absolute measure, based on the cost of a particular basket of consumption goods. Although the cost of the basket is adjusted for price changes, the market basket itself is not adjusted for the changes in the overall standard-of-living that occur as real incomes rise. Nonetheless, both the replacement rate and the poverty rate are useful summary statistics.

The analysis of any reform proposal should address the likely impacts on the replacement rates of future recipients -- retirees, survivors and the disabled -- by income level. Who is likely to gain and who is likely to lose from the changes proposed? The analysis should pay particular attention to those at the lower end of the income distribution, those most dependent on the income redistribution built into the Social Security benefit structure.

A closely related issue is that of risk -- who will bear the risk if the forecasts of the future turn out to be inaccurate, as they undoubtedly will? In a defined-benefit plan, the risk falls primarily on the entity who defined the benefit, the government (and therefore the taxpayers) in the case of Social Security, or the firm sponsoring an employer pension plan. In a defined-contribution plan, the financial risk of disappointing performance falls on the individual. Analysis of reform proposals should consider not only the most likely forecast, but also evaluate the income adequacy implications of a range of future economic scenarios.

These forecasts are difficult, particularly if they are projected many years into the future and especially if they include anticipated stock market returns. The difficulty is compounded by the fact that changes in the Social Security system may well result in changes in the other sources of future income (such as earnings, employer pension benefits and asset income), as employers and individuals respond and react to the new Social Security environment. These issues will be discussed below.

**Individual equity.** Whereas income adequacy is the oldest (and, I would argue, the most important) criterion for evaluating the Social Security program, individual equity may be the newest. This criterion takes an individual rather than a social insurance perspective, and analyzes the relationship between an individual's total contributions to the system (the payroll tax paid by the employee and employer) and the total benefits that he or she is likely to receive in return.

Historically, individual equity has not been an important part of the Social Security debate. One reason is that before the system matured, all cohorts of retirees received several times what their (and their employers') contributions would have produced had the funds been invested in similarly safe investments, such as government bonds. Favorable demographics -- the high ratio of Social Security contributors to beneficiaries in the early years of the program -- coupled with significant real wage growth permitted generous benefits to retirees without undue burden on workers and employers.<sup>6</sup> Because of the progressive nature and the gender neutrality of the benefit structure, the "rate of return" varied with income level (it is higher the lower one's average lifetime earnings) and gender (since women live longer than men).<sup>7</sup> But Social Security was a great deal -- a great investment, in today's parlance -- for all types of current and prior retirees, and therefore individual equity was not a bone of contention.

But this will not be the case for future cohorts of retirees. Because of the changing demographics, the aging of the population and the decline in the ratio of Social Security contributors to recipients, rates of return from Social Security are falling. Steuerle and Bakija (1994; table A.7) estimate that the net transfer for average- and high-wage single males has

already turned negative, and will do so for high-wage single females and high-wage two-earner couples turning 65 in the years 2000 and 2005, respectively.<sup>8</sup>

In 2030, when the youngest of the baby-boomers will have reached 65, high-wage single men can expect to receive from OASI less than half of what their and their employers' contributions could have provided had they been invested at a two percent real rate of return (Steuerle and Bakija 1994: table A.8). For high-wage females and high wage two-earner couples, analogous figures in 2030 are about 60 and 75 percent.<sup>9</sup> The absolute size of the expected net transfers from these individuals to Social Security (the difference between the value of the expected OASI benefits and the proceeds from investment) at a two percent real rate of return, are large -- approximately \$250,000 (in 1993 dollars), \$190,000 and \$180,000 for high-wage single males, single females and two-earner couples, respectively, who turn 65 in 2030 (Steuerle and Bakija 1994: table A.6). The negative transfers are slightly larger for subsequent cohorts.

To many young workers, therefore, participation in the Social Security system no longer looks like a good investment. It is not surprising that "money's worth" calculations are now part of the reform debate and that they have engendered some adverse reactions to the traditionally very popular Social Security system.

The comparison here is between expected lifetime Social Security contributions and benefits, and the goal is a closer relation between the two. According to this individual equity criterion, the Social Security system should look more like a savings account or an IRA, and less like the income redistributive system that is designed to be. In evaluating reform options, analysts should compare the expected internal rates of return (or the net transfers) of proposed changes with those under the current system, both across generations (that is, by age cohort) and by income class and demographic type within generations.<sup>10</sup>

**Economic growth.** Social Security expenditures are the largest single item in the Federal budget. In 1996, Social Security outlays, excluding Medicare, totaled \$354 billion, nearly a quarter of all Federal government expenditures, and nearly 5 percent of gross domestic

product. Old-age, survivors and disability benefits were paid to 44 million recipients, and payroll taxes were collected from 144 million workers (Board of Trustees 1997: 4). Changes in a program of this magnitude can have significant macroeconomic effects, and can influence the growth rate of the economy.

As mentioned above, economic growth is of paramount importance because the consumption of future retirees will come from the goods and services being produced at that time. Social Security benefits and other sources of retiree income will provide a claim on those future goods and services. Much of the discussion about Social Security reform focuses on the distribution of future output -- the share that retirees will or should have. As important as the share of the pie, however, is the size of pie being shared.

There are two primary ways in which the Social Security program can affect economic growth, through its influence on individual labor-leisure choices and through its impact on aggregate national saving.

Individual labor-leisure choice. The Social Security system can affect labor supply decisions through the typical income and substitution effects, both during the work life and, more importantly, at retirement. To the extent that participation in the system increases the lifetime wealth of participants, as it has for the vast majority of current and previous retirees, it should increase the consumption of all normal goods, including leisure. Much of this increased leisure has been taken in the form of earlier retirement. Research suggests that increases in Social Security wealth may be responsible for about one-third of the post-war decline in elderly labor force participation rates.<sup>11</sup>

But Social Security taxes and benefits also affect the net wage rate earned by workers. To the extent that employees view their mandatory OASDI contributions as a pure tax (i.e., do not associate the contributions with increases in benefits later on), the payroll tax lowers the marginal wage rate for those earning below the maximum taxable earnings.<sup>12</sup> This could have a distortionary affect on labor supply, although evidence suggests that it is a small one, at least for primary workers (Council of Economic Advisors 1997: 115). Once one is eligible for Social

Security benefits, however, the incentives get more complicated. After age 62, additional earnings over the exempt amount have two offsetting effects.<sup>13</sup> They decrease current benefits (to zero, if earnings are high enough), but they also increase the future benefit stream, both because of the recalculation of average earnings and because of the delayed retirement credit. Depending on one's discount rate, life expectancy and average lifetime earnings, the net result could be an increase or a decrease in expected total benefits -- an increase or decrease in lifetime Social Security wealth. One's true compensation during the year of work includes both the paycheck and the change (increase or decrease) in social Security wealth. If the total amount of expected Social Security benefits declines with additional work, then Social Security acts as a tax, or a pay cut. To the extent that additional work provides both a paycheck and an increase in lifetime benefits, Social Security acts as a subsidy, and increases the true wage rate.

Considerable research has shown that workers do respond to these incentives, and that they are more likely to leave a job and often the labor force as well, the stronger the retirement incentives (the implicit pay cuts) they face.<sup>14</sup>

Reform proposals that either tighten the relationship between contributions and benefits or make the benefit calculation rules at retirement more age-neutral (i.e., the total expected value of future benefits does not depend on when benefits are first claimed) reduce the labor market distortions of the system, and would be viewed favorably according to this criterion.

Individual consumption-saving choice. Social Security rules can influence not only the allocation of time between work and leisure, as discussed above, but also the allocation of income between consumption and saving. Most analysts believe that Americans save too little, both from a macroeconomic perspective and with respect to maintaining consumption levels after retirement. Americans save less than they used to, and less than the citizens of many other industrialized countries.<sup>15</sup>

Economic theory and common sense (synonyms, according to some!) suggest that the public provision of retirement income should affect the amount of discretionary private saving that individuals will do for retirement. The higher the Social Security benefits promised or the

level of private saving mandated (as proposed in two of the Advisory Council plans), other things equal, the less one has to save through other means to maintain a given standard of living. But other things may not be equal. Retirement decisions are affected by the generosity of Social Security benefits (the net transfer from the system to the individual), which creates an offsetting effect. An increase in benefits (and an earlier planned labor market exit) could induce an increase in private saving to finance the additional years of retirement (Council of Economic Advisors 1997: 109).

The theoretical effect of the Social Security system on private saving is ambiguous, as is the empirical literature.<sup>16</sup> Some authors have found substantial negative impacts on private saving (Feldstein (1974) is the classic article here), while others have found small or even positive impacts (Munnell 1977; Danziger, Haveman and Plotnick 1981). This same ambiguity is found in the related literature on the impact of government savings incentives, such as favorable IRA and 401(k) tax provisions, on net private savings. Some authors find considerable net new saving, while others, sometimes analyzing the same data, find that savings in these vehicles represents only a reallocation of saving that would have occurred in other forms. This debate is nicely summarized by the titles of two recent reviews of the literature, "How Retirement Saving Programs Increase Saving" and "The Illusory Effects of Saving Incentives on Saving."<sup>17</sup>

Regardless of the difficulty of doing so, the impact of proposed Social Security reforms on the private saving decisions is an important evaluation criterion, because the sign and magnitude of the effect will influence both the amount of asset income that individuals can rely on in retirement, and the amount of capital accumulation (and therefore the future production capabilities) of the economy at large.

Aggregate national saving. Private saving by individuals is only one part of aggregate saving. Another key component is federal government saving, through the Social Security program directly and through the rest of the federal budget.

The Social Security system is currently running a large surplus. In 1996, an OASDI surplus of \$71 billion was added to trust fund reserves and this lowered the official federal government deficit by the same amount. The annual OASDI surpluses are scheduled to increase to about \$130 billion per year early next century, and then fall, turning negative by about 2019, according to the intermediate forecasts of the Social Security Trustees (1997: table II.F12 and figure III.B1). Anticipated revenues and withdrawals from OASDI reserves would then be sufficient to pay benefits until the year 2029.

Social Security reform could change government saving in two ways, by directly affecting the revenue or expenditure stream of Social Security, and by indirectly affecting other government decisions. For example, reform proposals that reduce Social Security surpluses (e.g., by diverting some of the revenue stream into individual savings accounts) would increase the measured government deficit. How would the federal government respond to the increased deficit? Would Congress attempt to maintain the current budget deficit path by reducing spending or raising other taxes to replace the diverted revenue stream? If so, this would represent an increase in government savings. Or would Congress slow the time path to budget balance, by maintaining current expenditure and taxation plans, and by borrowing the diverted funds from the market rather than from the Social Security trust funds? In the latter case, the measured increase in private saving (the new savings accounts) would be offset by the increase in government dissaving (the higher measured deficit) and national saving would remain unchanged.<sup>18</sup>

Forecasts of this type are extremely difficult, because they require prediction of future Congressional behavior. Nonetheless, they should be included in the discussion, because the behavioral decisions made could have significant effects on aggregate national saving and therefore on future economic growth.

**Other considerations.** Certain other issues do not fit neatly into the categories of income adequacy, individual equity and economic growth, but may provide important criteria for evaluating and choosing among reform alternatives.

Administrative costs. Because of the large scale and the mandatory nature of the Social Security system, administrative costs are very low, only 0.9 percent of benefits in 1996 (Board of Trustees 1997: 9). Two of the three reform options proposed by the 1994-96 Advisory Council include the creation of mandatory individual retirement accounts over which participants would have some management discretion.

Olivia Mitchell (1996) has estimated the administrative costs that might accompany alternatives to the current Social Security system, by analyzing the administrative costs of mutual funds and defined-contribution employer pensions, like 401(k) plans. She argues that the additional costs of investing some of the Social Security trust fund reserves in the equities market (as proposed by the Maintenance of Benefits plan) would be very small, as long as the investment strategy remained passive, and political pressures to favor or avoid particular industries or stocks were resisted.<sup>19</sup> On the other hand, proposals that involve the investment of mandated saving by individuals, like the Personal Security Accounts plan, could result in considerably higher administrative and management costs, depending on the details of the plan; for example, the breadth of investment options allowed, the frequency of asset reallocations permitted, whether the new saving accounts were added to existing mutual funds or 401(k) plans, and whether the accumulated assets could be withdrawn in a lump-sum or had to be converted into an annuity.<sup>20</sup> Mitchell (1996: 42-43) points out that these additional costs would not just be new fees for the same service (i.e., a pure cost increase), but rather would be associated with new investment and portfolio options for participants.

In analyzing the three reform proposals, the 1994-96 Advisory Council (1997: 35) assumed administrative costs of 0.5 basis points per year for the Maintenance of Benefits plan, 10.5 basis points for the passively-managed Individual Accounts plan, and 100 basis points (which equal 1 percent) per year for the Personal Security Accounts plan.

Flexible investment options offer advantages but they come at a cost, and both should be considered when evaluating these or any other Social Security reform proposals.

Confidence in the Social Security system. Public opinion polls reveal, at the gut level at least, a widespread lack of confidence in Social Security. In a 1994 EBRI/Gallup poll, for example, 43 percent of those surveyed stated that they were "not confident" that Social Security income would be available throughout their time of retirement (Reno and Friedland 1997: 187). (Analogous numbers for employer pensions (24 percent) and personal savings (19 percent) were much lower, indicating more confidence in these retirement income components.) There were large differences by age. Among respondents under the age of 55, over half were "not confident" in the Social Security program, compared to only 16 percent of those aged 55 or older.

Further investigation clouds the interpretation of these responses, however, since in the same EBRI/Gallup survey (in 1991), 93 percent of the respondents said that they expected to receive Social Security benefits, and nearly half (45 percent) said they expected they would be "a major source" of their retirement income (*ibid.*, p. 188). (Only 27 percent expected Social Security benefits to be their "most important" source of income.) In addition, the vast majority of the population appears to support the Social Security program, even if they harbor some doubts about its future viability. In a 1994 Gallup poll, about 80 percent of people not receiving Social Security benefits said that they favored or strongly favored the fact that "part of every working person's income goes to support the Social Security program," and nearly three-quarters opposed a decrease in spending on Social Security benefits (*ibid.*, p. 186). Informational focus groups conducted in 1994 also established that the level of confidence rose as people were educated about the program (*ibid.*, p. 188).

Regardless of whether these survey results reflect snap reactions or thoughtful judgments, they are a matter of concern, since the future of the Social Security system depends on the political support of the population. Unless the goal of a proposal is to eliminate the program, a reasonable criterion is the likely impact it would have on public confidence, both through the financial details of the proposal and through the effects of any educational components it might include.

Complexity and ease of transition. Although some of the details of the Social Security program are complicated, Americans have a good understanding of its basic goals and features. Most know that Social Security benefits are based on earnings and are financed by payroll taxes, that current taxes largely pay for current benefits, and that benefits are not directly means-tested (*ibid.*, p. 183). As noted above, the vast majority claim that they expect Social Security benefits to be part of their income in retirement.

Reform will revise the current rules, as it must. An important consideration is the nature of the transition from the current system to whatever replaces it. Those nearing retirement age should be protected from sudden and dramatic changes in what they have been led to expect.<sup>21</sup> And for all participants, young and old, one should consider the complexity of any proposal, and ask whether citizens can be expected to understand the important parameters of the new system. It may be more difficult to maintain political support for a system whose features are only vaguely understood by the population.

Changes in employer pension plans. Because of the magnitude of the Social Security system and the number of participants and beneficiaries, changes in the system can be expected to have impacts in other parts of the retirement environment and in the economy as a whole. The private savings response of individuals and the behavioral response of Congress to possible changes in the federal budget deficit were mentioned above. Equally important are the responses of employers through their pension plans. Since pension benefits are a key component of retirement income (about half as important as Social Security benefits, in the aggregate) and because pension receipt is rarely associated with extreme poverty, changes in pensions in response to Social Security reform could have important implications for the economic well-being of the elderly.<sup>22</sup>

Some response to changes in Social Security benefits would be automatic under current rules, because nearly two-thirds of full-time pension participants are in plans that are formally integrated with Social Security (Mitchell 1992: table 9.11).<sup>23</sup> This means either that pension benefits are directly reduced by some proportion of Social Security benefits received, or that the

pension formula applies a lower rate to earnings that are subject to Social Security tax than to earnings that are not (*ibid.*). Unless these rules were changed, part of any Social Security benefit decrease would be automatically offset for some pension recipients.

Of more interest, however, are the discretionary changes that might follow Social Security reform. Would a decline in the size of Social Security's defined benefit (e.g., as in the Personal Security Account plan) increase the demand by employees for defined-benefit employer pensions? Would a universally mandated defined-contribution plan result in a decrease in the number of these plans at work, or a decrease in the matching rate offered by employers? Would employees contribute less to these plans, even if they were still available? In general, anyone already saving can offset at least part of any new saving mandate, by simply saving less elsewhere.<sup>24</sup> One "elsewhere" is in the discretionary component of employer-based pension saving.

Since private and institutional savings (through the Social Security system or through employer pension plans) are all means to the same end, it is plausible that there would be offsetting effects to major Social Security reform. It is difficult to predict what would happen to the structure of employer pensions or to the total contributions of employers and employees, but the impact of any such changes could be very important.

Social cohesiveness. Social Security is one of the few programs in which nearly all Americans participate, either directly as workers or indirectly as dependents enjoying survivor insurance. Many have lamented the decline of common purpose in the United States.<sup>25</sup> An important criterion for consideration is what effect particular reform would have on the viability of the Social Security program in the future.

Opponents and proponents of radical reform acknowledge the importance of this issue, but to opposite purpose. Those opposed to the partial privatization component that exists in two of the three Advisory Council plans fear the long-run political implications of formally separating the Social Security program into two parts. They foresee the development of one component of primary interest to the poor -- the defined-benefit part, the means of redistribution -- and another

part of primary interest to the middle and upper classes --the defined-contribution, mandatory saving part.<sup>26</sup> They wonder if the defined contribution part would take on a welfare aura, like Supplemental Security Income, especially in the PSA plan, where the income redistribution occurs through a flat-rate benefit, independent of earnings. If the perception of this component does change, privatization opponents worry that the social insurance aspect of the program, its original reason for existence, will atrophy over time, and higher and higher proportions of the payroll tax would be moved into the upper tier.

Proponents of privatization, on the other hand, claim that political support for the present Social Security system will inevitably decline over time, as it becomes a bad investment for more and more involuntary participants. They argue that continued political support for the system requires radical change -- the replacement of the old engines of population and real wage growth with the new engine of the equities market.

Who is right? I do not know, but I suspect that these long-range political issues will turn out to be as important to the well-being of future retirees as are the economic forecasts of benefits under the various reform proposals.

The financial health of the Social Security system. This was the last of the six criteria adopted by the Advisory Council's Technical Panel on Trends and Issues in Retirement Saving. It is obviously important, since the unfunded liability facing the system is largely what prompted this round of interest in Social Security reform. Any proposal for change should be analyzed for its long-range fiscal implications. Since all three of the Advisory Council proposals eliminate the 75-year unfunded liability, this criterion will not help us differentiate among them, but it may distinguish them from other reform plans that do not achieve or even move us away from this goal.

## **Summary**

Because of the favorable age distribution of the population during the maturing of the U.S. Social Security system -- the high ratio of contributors to beneficiaries -- the program was able to make a major contribution toward the economic security of low-earning workers, and

simultaneously provide an outstanding return on the contributions of all cohorts of Americans, rich and poor alike. In the future, however, this will not be possible, and the inherent tension between the criteria of income adequacy and individual equity will become clear. Income redistribution explicitly treats different people differently -- that is the point of it. The primary goal of the Social Security system, income adequacy for its recipients, must now be balanced against the political implications of a mandatory program in which certain citizens can expect to be significant net contributors over their lifetimes.

The Social Security system should not be viewed solely as an alternative savings vehicle. Social insurance provides more than a return on investment. It provides to individuals insurance against certain risks, and to society some protection against the inequalities and inequities that are inevitable in an advanced capitalistic state. But these benefits must be weighed against their costs, and under the current rules, these costs will differ significantly by income class.

In this paper, we have discussed various criteria with which to evaluate proposals for Social Security reform -- income adequacy, individual equity and economic growth. We have also mentioned several other important issues for consideration, including the complexity and administrative costs of any new system, its effects on public confidence and social cohesiveness, and how other components of income security in old age, particularly employer-sponsored pensions, would be likely to change.

Most analysts would agree that some variant of the criteria discussed in this paper should be part of the Social Security reform debate, although they might disagree about their relative importance. I agree with the Council of Economic Advisors (1997: 117), who ended their discussion of the economic challenges of an aging population by concluding that "a variety of approaches [to Social Security reform] should be considered, but any possible changes must ... ensure that the benefits of reduced poverty and increased economic security for the aged and disabled are not put at risk."

**Table 1**

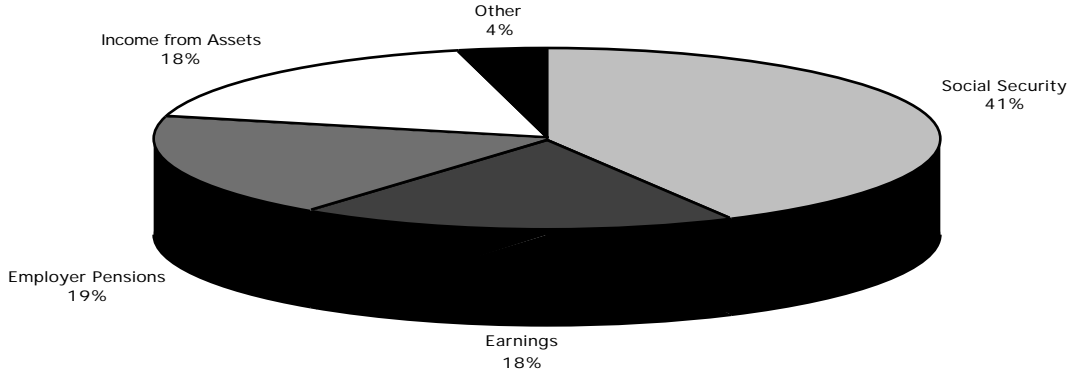
Income Shares for Aged Units Age 65 or Older, 1994  
by Age and Income Quintile  
(vertical percentage)

<u>Source of Income</u>	total	AGE				
		65-69	70-74	75-79	80-84	85+
Social Security	42	31	43	48	56	57
Earnings	18	33	16	8	5	2
Employer Pensions	19	18	21	20	17	13
Income from Assets	18	15	17	20	19	22
Other	4	4	3	4	3	5

<u>Source of Income</u>	total	INCOME QUINTILE				
		First	Second	Third	Fourth	Fifth
Social Security	42	81	81	66	48	23
Earnings	18	0	2	6	11	29
Employer Pensions	19	3	7	14	24	21
Income from Assets	18	3	5	10	14	24
Other	4	13	4	4	3	3

Source: Grad (1996), tables VII.1 and VII.5

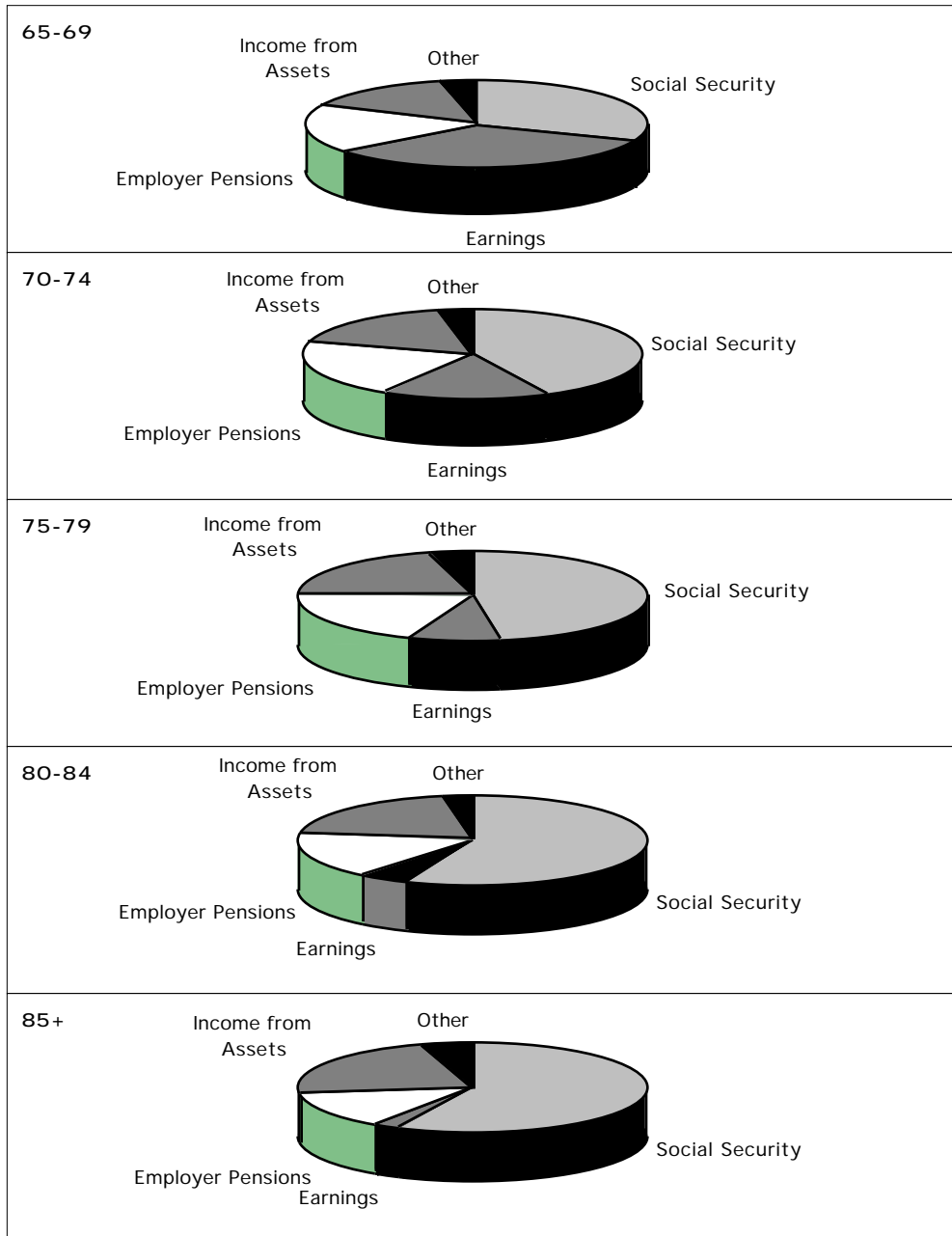
Figure 1  
Income Shares for Aged Units Age 65 or Older, 1994



Source: Grad (1996), table VII.1

**Figure 2**

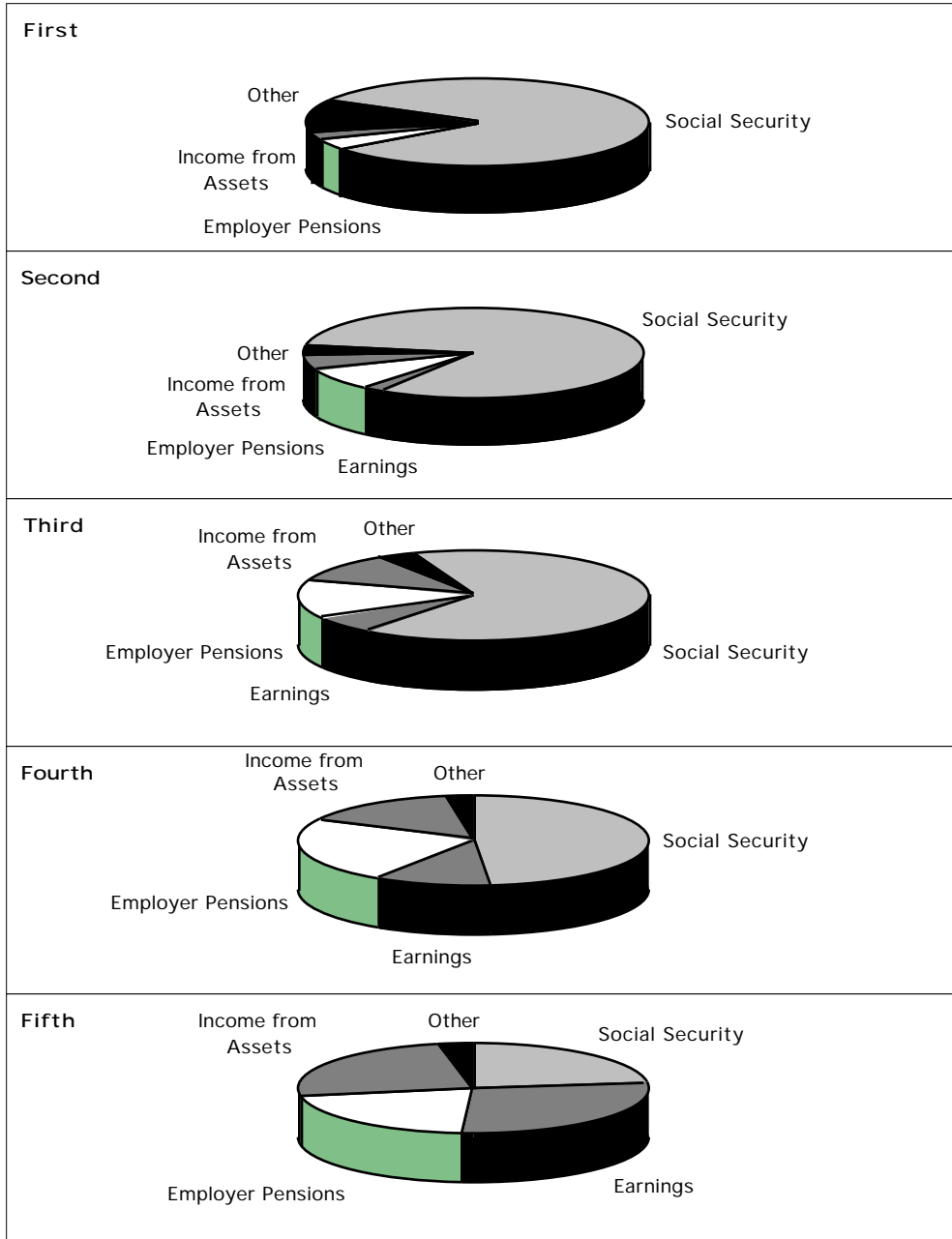
**Income Shares for Aged Units, by Age, 1994**



Source: Grad (1996), table VIII.1

**Figure 3**

Income Shares for Aged Units, by Income Quintile, 1994



Source: Grad (1996), table VIII.5

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<sup>1</sup> I would like to thank my colleagues Eric Kingson and John Williamson, as well as Olivia Mitchell and Robert Myers for insightful comments on an earlier draft of this paper.

<sup>2</sup> As an example, a recent Advisory Commission to study the consumer price index estimated that the CPI overstates changes in the cost-of-living by about 1.1 points per year. Were this estimate adopted by the Social Security actuaries, about two-thirds of the 75-year deficit would disappear.

<sup>3</sup> See Advisory Council (1997: 25-33) for the details of these proposals. See Quinn and Mitchell (1996), the National Academy of Social Insurance (1996) or Olsen (1997) for a summary of the plans.

<sup>4</sup> All other sources of income, including public assistance (e.g., Supplemental Security Income) provided only 4 percent of aggregate income for the elderly in 1994.

Employer pensions include private pensions and annuities, government employee pensions and railroad retirement pensions. Some income from pension accumulations may be mislabeled as asset income, if lump sum pension distributions were invested in financial instruments, and then listed as interest or dividends. For a detailed analysis of this issue, see Woods (1996).

<sup>5</sup> The Committee on Economic Security, whose recommendations established the basic framework for the U.S. Social Security system, rejected two other approaches to old-age income security -- a noncontributory, universal pension system funded by general revenues, and a means-tested program (Thompson and Upp, 1997). For a concise history of the early decades of the Social Security program, see Berkowitz (1997) or Bryce and Friedland (1997).

<sup>6</sup> In 1960, the maximum annual OASDI contribution of the employee and employer combined was only \$288 (about \$1500 in 1996 dollars). In 1970, the maximum was \$655 (about \$2650 in

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1996 dollars). In 1997, the maximum combined OASDI contribution is \$8110 (Annual Statistical Supplement 1996, table 2.A4).

<sup>7</sup> Estimates of real rates of return in the Old-Age and Survivors components of Social Security, net transfers (OASI benefits - OASI taxes paid), and the ratio of benefits to taxes for various types of participants can be found in Steuerle and Bakija (1994: table A.3). The authors calculate these "money's worth" estimates for single males, single females, one earner couples and two-earner couples at three different earnings levels, for cohorts turning 65 at 5-year intervals from 1940 to 2050.

The House Committee on Ways and Means (1993: 1301-1305) calculates net transfers and the ratio of benefits to taxes for men and women at three earnings levels retiring in 1980, 1992 and 2000. Finally, Burtless and Bosworth (1997: figure 2) have calculated internal rates of return on OASDI contributions, for low-, average- and high-wage workers, by birth cohort. All of these estimates tell the same story -- low-wage workers do better than high-wage workers, and early cohorts (those born in the 1920s and 1930s) have done better than subsequent cohorts will.

<sup>8</sup> Steuerle and Bakija (1994) use a 2 percent real rate of return on alternative investments. An internal rate of return from the Social Security system in excess of this implies a net transfer to the individual; a rate of return less than 2 percent real implies a negative transfer -- a transfer from the individual to others in the Social Security system. The estimates I am using adjust for the chances of death before receiving old age benefits. Steuerle and Bakija also calculate net transfers assuming survival to age 65, and in these calculations the bad news is delayed a bit, but the trends are identical.

<sup>9</sup> Because of the progressive benefit structure, low-wage workers of all types continue to receive more than a two percent real rate of return from the Social Security system, even in 2050. Because of the subsidy in the spousal benefit, single-earner couples also continue to do well.

<sup>10</sup> Leimer (1995) provides an excellent nontechnical discussion of frequently used money's

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worth measures, the assumptions behind them, and their uses and limitations.

<sup>11</sup> See Hausman and Wise (1985) and Ippolito (1990). Hurd and Boskin (1984) attributed nearly all of the decline in the labor force participation rates of older Americans to the generosity of Social Security. Moffit (1984) is skeptical of the claims, and points out that aggregate Social Security wealth rose significantly in the 1950s (because of increases in coverage -- more categories of workers being included in the system, and enjoying large windfall gains) without any dramatic declines in labor force participation rates.

<sup>12</sup> In fact, the payroll tax is not a pure tax for most workers, since the earnings associated with the payroll tax increase future Social Security benefits. As discussed above, for most current and past retirees, Social Security has been a subsidy to work, not a tax, since each dollar of contribution has resulted in several dollars of eventual benefit. For workers today, however, this will not be the case.

<sup>13</sup> In 1997, beneficiaries aged 62-64 can earn up to \$8,640 without losing any Social Security benefits. Beyond that, benefits are reduced by \$1 for each \$2 earned. For those aged 65-69, the exempt amount is \$13,500, and the benefit loss is \$1 for each \$3 earned. The exempt amount for those 62 to 64 is indexed to average earnings in the country. For those 65 to 69, legislation will increase the exempt amount dramatically, to \$30,000 by the year 2002. At age 70, there is no earnings test, and one can receive full benefits regardless of earnings.

<sup>14</sup> For more discussion of these issues and this literature, see Quinn, Burkhauser and Myers (1990), Quadagno and Quinn (1997) or the Technical Panel (1997: 13-20).

<sup>15</sup> Gramlich (1997: table 9.1) estimates that private savings, calculated from the National Income and Product Accounts, has dropped by about one third (as a percentage of gross national product) since the 1960s. Aggregate national savings has dropped much more dramatically, from 8.6 percent (1962-1965) to only 2.0 percent (1991-1994) of GNP, primarily because of the large increases in federal government deficits.

On an individual level, Poterba, Venti and Wise (1996) estimate that the median level of

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personal financial assets (excluding housing and estimated Social Security and pension rights) of households with heads aged 55 to 64 was only \$8,300 in 1991.

Trends and issues in national saving are discussed by the Technical Panel (1997: 41-48).

<sup>16</sup> The Council of Economic Advisors' (1997: 108-110) report contains a concise discussion of the effects of Social Security on savings, distinguishing among three different time periods, the start-up phase, the current mature system, and the future.

<sup>17</sup> See Poterba, Venti and Wise (1996) and Engen, Gale and Scholz (1996), both in the same issue of the Journal of Economic Perspectives.

<sup>18</sup> This assumes that individuals do not offset some of the mandated savings themselves. Bosworth (1996: 104-105) and Burtless and Bosworth (1997: 8) argue that it is difficult to use Social Security accumulations to augment national savings, because, in practice, the surpluses are integrated into the federal budget and treated like any other revenue source. This same argument suggests, however, that reducing Social Security surpluses, as the Personal Security Account plan proposes, might lead to Congressional actions to offset this loss in revenues, and therefore an increase in national saving.

<sup>19</sup> Mitchell (1996: 38-39) estimated that these administrative costs would be at the lower end of the 1 to 20 basis point range.

<sup>20</sup> The Individual Accounts proposals would permit participants to select from a modest number of investment vehicles managed by the government (a TIAA-CREF model), and would require conversion of the assets to an annuity when they are claimed. The Personal Security Accounts plan would have individuals invest their mandated savings on their own (a 401(k) model) within some regulatory framework to be determined, and would involve lump-sum dispersal at or after age 62.

<sup>21</sup> The most radical of the three Advisory Council proposals, the Personal Security Account plan, would exempt current participants aged 55 or older in 1998 from the basic structural change to a two-tiered system. They would continue in the current system, and receive the benefits promised

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under current law, subject only to changes in retirement ages and benefit taxation that apply to all. Those under 25 in 1998 would lose any rights under the old system, and receive benefits only under the new system. Those aged 25 to 54 would receive a combination of their benefits under the current system and the Tier I (flat rate) benefit under the new proposal, each prorated by the number of years spent working in each of the two systems (Advisory Council 1997: 30-31).

<sup>22</sup> Grad (1996; tables I.5 and VII.5) reports that only 7 percent of aged units in the bottom income quintile report any employer pension income, and that it amounts for only 3 percent of their total cash income.

<sup>23</sup> This estimate is based on 1989 data. Mitchell notes that there was little change in the percentage of participants in integrated plans between 1985 and 1989.

<sup>24</sup> Theoretically, even someone not saving at all could offset the mandate, by borrowing today to offset the required saving, and repaying the debt when the assets are made available in the future. For most of those without savings, this avenue is probably unlikely.

<sup>25</sup> Putnam (1995) documents numerous examples of declining civic engagement, in government affairs (declining voter turnout), religious affiliation (declining church attendance), labor unions (declining membership), civic and fraternal organizations (numerous examples of decline) and even participation in bowling leagues (down 40 percent between 1980 and 1993, while the total number of bowlers increased by 10 percent!) Although he does acknowledge some countertrends, Putnam concludes that social capital in the United States is eroding.

<sup>26</sup> In the Personal Security Account plan, for example, maximum-wage workers, in the steady-state, are predicted to receive about 80 percent of their total benefits from the upper tier, compared to only 40 percent for low-wage workers. In the Individual Accounts plan, with a smaller defined-contribution part, the analogous numbers are 40 and 20 percent (Advisory Council 1997: 47).

