NATIONAL ACADEMY OF • SOCIAL INSURANCE

SOCIAL INSURANCE UPDATE

Volume 1 • Issue 3
December 1996

ADVISORY COUNCIL ON SOCIAL SECURITY TO REPORT SOON

The 1994-96 Advisory Council on Social Security is expected to report by the end of this year. Unlike many past councils, it did not agree on legislative recommendations. Rather, council members are offering three sharply different models for the future of Social Security. The council did agree on the size of the financing problem and some individual proposals are supported by a majority of members. The chart enclosed in this *Update* summarizes details of the three plans.

Mandate

For over 30 years, the Social Security Act has called for an Advisory Council on Social Security to be appointed every 4 years. By law, its purpose is to review the status of the Social Security and Medicare trust funds in relation to long-term commitments of these programs and to review the scope of coverage, adequacy of benefits and all other aspects of the programs. This is the last such council. Legislation in 1994 ended the requirement when it created an on-going advisory board for the independent Social Security Administration.

The prior law required the Secretary of Health and Human Services to appoint a chair and 12 other council members who "to the extent possible represent organizations of employers and employees in equal numbers, and represent the self-employed and the public." Members and their affiliations are listed on page 2.

Points of Agreement

The council agreed to define the size of the financing problem by the "best estimate" projections in the 1995 Social Security trustees report, which showed:

- A long-range deficit of 2.17 percent of taxable payroll over the next 75 years (equivalent to a tax increase today of about 1.09 percentage points for employees and employers, over the 6.2 percent they each now pay);
- Annual surpluses of income over outgo in the early decades, with a build up of reserves that will begin to be drawn down after 2019 and will be depleted by 2030. At that time, income is projected to

Continued on pg. 2

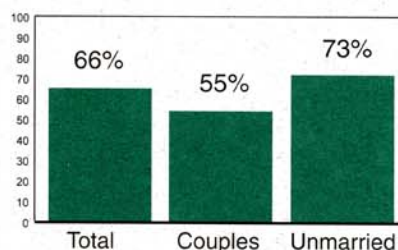
ACADEMY LAUNCHES NEW STUDY:

Evaluating Issues in Privatizing Social Security

Not since the 1930s has there been such widespread interest in radically restructuring retirement income in the United States. Driven by concerns about paying for the baby boomers' retirement, proposals to fundamentally restructure Social Security have been placed on the national agenda by members of Congress, private individuals and groups, and most recently by members of an official Advisory Council on Social Security.

Proposals to "privatize" Social Security would substitute an individual savings, or defined contribution, plan for all or part of the benefits retirees receive. Other proposals would change the investment policy of the Social Security trust funds by putting part of the funds in private securities. Both kinds of proposals have far-reaching implications that are not yet fully understood.

Social Security is important to Americans of all ages. Virtually all workers and their employers contribute to it through



most all elderly Americans receive it; about 2 in 3 elderly beneficiaries rely on it for more than half their income (see chart). Social Security has popular support, but it is not in financial balance over the long term

Continued on pg. 5

Advisory Council, Continued from pg. 1

cover only about three-fourths of benefit costs.

- A worsening financial imbalance after 2030. With no change in policy, by the 75th year benefits are projected to exceed income by about 5.71 percent of taxable payroll.

The council further agreed on two goals for reform: to eliminate the 2.17 percent average deficit; and to balance the fund at the end of the 75-year period and beyond. The latter goal aims to avoid the disappointment that followed the Social Security reforms of 1983. They eliminated the 75-year deficit then, but later projections again showed deficits, in part because the system was not in balance beyond 75 years.

While the three competing plans offer sharply different models for the future of Social Security, they also have common features. The following individual proposals have majority support in that each appears in at least two of the three plans.

1. Extend Social Security coverage to all newly-hired State and local government workers who are not already covered.

2. Assume that the correction of the upward bias in the consumer price index (CPI) announced by the Bureau of Labor Statistics in March 1996 will slow the cost of living adjustment (COLA) in future Social Security benefits by 0.21 percent.

3. Increase from 35 to 38 the number of years of a worker's earnings that are used to compute benefits. This would lower average benefits for future retirees by about 3 percent.

4. Tax Social Security benefits in the same way that contributory defined-benefit pensions are treated under the federal income tax and deposit the new revenues in the Social Security trust funds. That is, benefits would be taxed to the extent they exceed what workers paid in.

5. Accelerate the increase in the normal retirement age (NRA) at which full Social Security benefits are paid, so that it will reach age 67 in 2011 instead of in 2022[1]. After 2011, the NRA would increase with longevity (estimated to be an increase of 1 month every 2 years).

If taken together, these five changes would eliminate more than two-thirds of the long-range deficit by reducing it from 2.17 to about 0.64 percent of taxable payroll and would shift the trust fund exhaustion date from 2030 to 2052 (table 1).

Advisory Council on Social Security

Representing the Public:
Edward M. Gramlich*, Chair
Dean of the Institute of Public Policy
University of Michigan

Robert M. Ball*
Consultant
Commissioner of Social Security, 1962-73

Ann L. Combs*
Principal
William M. Mercer, Inc.

Thomas W. Jones*
President and Chief Operating Officer
TIAA-CREF

Fidel Vargas
Mayor
City of Baldwin Park, CA

Carolyn L. Weaver
Director of Social Security and
Pension Studies
American Enterprise Institute

Representing the Self-Employed:
Edith U. Fierst*
Attorney-at-Law
Fierst & Moss, P.C.

Representing Employers:
Joan T. Bok
Chairman
New England Electric System

Sylvester J. Schieber*
Director of the Research and
Information Center
Watson Wyatt Worldwide

Marc M. Twinney
Director of Pensions
Ford Motor Co. (retired)

Representing Employees:
Gloria T. Johnson
Director of the Department of Social Action
International Union of Electronic,
Electrical, Salaried, Machine and
Furniture Workers, AFL-CIO

George Kourpias*
President
International Association of Machinists
and Aerospace Workers, AFL-CIO

Gerald M. Shea*
Assistant to the President for Govermental
Affairs
AFL-CIO

* Academy member

Three Competing Models

The **maintain benefits (MB)** plan is supported by six Council members — Mr. Ball, Ms. Fierst, Ms. Johnson, Mr. Jones, Mr. Kourpias and Mr. Shea. They would keep the existing benefit structure with changes 1-4 listed above.[2] In addition, all six support shifting from Medicare to Social Security the tax on Social Security benefits now going to the Hospital Insurance trust fund, to be phased in over 2010-2019. They do not support further raising the normal retirement age. The changes they favor would reduce the 75 year deficit from 2.17 to 0.80 percent of taxable payroll and would extend the year of trust fund exhaustion to 2050.

Poses Radically Different Solutions

For the longer term, advocates of the MB plan would increase projected trust fund income by investing part of the reserves in the private market. The investments would be passively managed by an independent board, akin to the board governing the federal employees Thrift Savings Plan, and the risks would be borne collectively. Finally, to ensure balance at the end of the 75-year projection period, they would schedule a payroll tax increase of 0.8 percent for employers and employees, each, to begin about 2045.

The **individual account (IA)** plan is supported by Mr. Gramlich and Mr. Twinney. In addition to changes 1-5 above, it would gradually ratchet down the benefit formula so that future benefits could be financed by the existing payroll tax. When phased in, the formula reduction would be about 17 percent for an average earner — more for higher earners and less for lower earners. When combined with the increase in the NRA, the ultimate benefit reduction for an age 65 retiree would be about 30 percent.

In exchange for the formula reduction, the plan adds mandatory individual savings accounts to be financed by new contributions from workers of 1.6 percent of their earnings starting in 1998. Workers would choose among a prescribed set of investments, which would be managed by the federal government, similar to the federal employees Thrift Savings Plan. The savings would be owned by individual workers, they could not be withdrawn before retirement, and at retirement the government would convert these accumulations into an indexed monthly annuity that would be paid for the rest of the retiree's life, or the life of the surviving spouse.

The **personal security account (PSA)** plan is supported by five members — Ms. Bok, Ms. Combs, Mr. Schieber, Mr. Vargas and Ms. Weaver. In addition to changes 1, 2 and 5 above,[3] it would transform Social Security into a two-tier benefit. The basic benefit would be a flat amount, equivalent to about 47 percent of the benefit paid to an average earner today.[4]

The second tier would be a personal savings account financed by shifting 5.0 percentage points of the existing employee payroll tax to that purpose. Workers would be free to invest their accounts in financial instruments widely available in the market. They could not withdraw the funds before retirement. At early retirement age they could use the funds as they saw fit. To continue to pay currently promised benefits would require new taxes during the transition. The transition would be financed by a new tax of 1.52 percent of payroll, starting in 1998 for 72 years, and by government borrowing during the first 40 years of the transition.

Table 1. Changes With Majority Support

Policy change	Change in 75-year deficit
1. Extend coverage to state and local workers	-0.22
2. CPI correction by BLS	-0.31
3. Increase computation period to 38 years	-0.28
4. Increase taxation of benefits	-0.31
5. Raise normal retirement age	-0.50
Total change in deficit*	-1.53
Remaining long-range deficit	0.64

Source: Office of the Actuary, Social Security Administration

* The total change is less than the sum of the changes for individual proposals due to interaction.

The Debate — Competing Rationales

Proponents of the **maintain benefits** plan believe that the American three-legged stool of retirement income is a success and should not be abandoned. They emphasize that Social Security is the foundation of that system — providing a compulsory public defined-benefit, earnings replacement plan that is supplemented by employer pensions and voluntary individual savings. They oppose shifting part of Social Security to individual savings accounts where individual workers bear the risk of investment returns. In their view, individual savings that fluctuate with market returns are an important supplement to Social Security, but a poor substitute for any part of it. They believe that splitting off part of Social Security into individual savings accounts would undermine retirement security and destabilize public support for the wage-related Social Security benefit because its value would be significantly eroded under the either of the competing plans.

> ***Social Security is the foundation of retirement income. Savings that fluctuate with market returns are an important supplement, but a poor substitute for any part of it.***
> — MB backers

They argue that the long-range financial imbalance in Social Security is not a crisis. It can be corrected without either large FICA tax increases or substantial benefit cuts. Investing part of trust fund reserves in the private capital market, they argue, would capture for Social Security financing some of the economic benefit to the nation of maintaining a significant reserve in the trust funds to partially advance-fund future benefit obligations.

Proponents of the **maintain benefits** plan strongly oppose the other two models. Many other choices are "second best" to their own plan, in their view. For example, instead of investing trust funds in the private market,

Continued on pg. 4

Advisory Council, Continued from pg. 3

they note that Social Security could be balanced by adopting the individual changes that they favor plus a modest increase in Social Security taxes or further reduction in benefits, or a combination of both.

Government investment in private markets is not desirable. Workers should chose their investments and bear the risks and returns individually.

— PSA backers

Proponents of both **individual accounts** and **personal security accounts** believe that Social Security reforms should provide more new national savings. Economic theory suggests that increased national savings will lead to increased productivity and national income, thus making more affordable the retirement of the baby boomers. Economists generally agree that if Social Security policy is to significantly increase national savings in the near term, either new contributions must be levied or benefits must be reduced, or both. Moreover, new net national savings would occur only to the extent that private savers did not reduce their other savings and that the government did not incur new offsetting debt.

Both plans involve new contributions — the new 1.6 percent contributions from workers in the IA plan and the 1.52 percent transition tax in the PSA plan. Both also reduce the defined-benefit portion of benefit payments much more than in the MB plan and both further raise the NRA. Both also lower disability benefits. Beyond these commonalities, the two plans differ significantly.

Backers of **personal security accounts** are opposed to centralized investment by the government in the private market, as would occur under the MB or the IA plans. The best way, in their view, is for workers to make their own investment decisions and bear the risks and returns individually. They argue that advance funding of PSAs produces real wealth to back a substantial portion of retirement benefits, unlike the current system, where promised benefits are backed only by the willingness of future generations to pay taxes to support them.

PSA backers further argue that the financial risks that workers face managing their own accounts may be no greater than the political risks to continued support for Social Security under current arrangements. In acknowledging the large transition costs their plan would entail, advocates of PSAs argue that these transition costs make explicit the future implicit obligations represented by promised Social Security benefits under current law.

Mr. Gramlich and Mr. Twinney arrive at the **individual accounts** approach by concluding that new revenues are needed, both to promote national savings and to support adequate income for future retirees. In their view, a tax increase to sustain current Social Security benefits would not be politically acceptable, but new contributions placed in individual accounts would be.

IA backers favor their plan over PSAs because it avoids the large transition costs of the PSA plan, it retains a higher basic defined-benefit component, it provides safeguards against unwise financial investments by workers, and it requires annuitization, which they believe is essential to ensure that the mandatory savings accounts do, in fact, contribute to income security throughout retirement.

Features of all three plans that involve investment in the private market raise a host of new issues that merit study. The Academy has convened an expert panel to study the new issues raised by plans to "privatize" all or part of Social Security benefits, as in the IA or PSA plans, or to change trust fund investment policy, as in the MB plan. (See story on page 1.) In the meantime, the council's anticipated report frames a debate about the future of Social Security. And the plans include a number of individual changes that, if taken together, would remove more than two-thirds of the 75-year deficit and would balance projected income and benefits for about 55 years.

New revenues are needed. A FICA increase to support Social Security would not be politically acceptable, but new contributions for individual accounts would be.

— IA backers

1 The new NRA first applies to a person reaching age 62 in the year specified.

2 Ms. Fierst does not support #3. While the three labor members have doubts about the proposal to extend coverage to state and local employees, they support the plan as a whole.

3 In addition to raising the NRA, this plan would raise the earliest eligibility age, now 62, along with the full benefit age.

4 The flat benefit would be indexed to keep pace with wage growth before retirement and would keep pace with CPI growth after retirement. Workers with less than 35 years of covered work would receive a reduced flat benefit — with 10 years of service, it would be 50 percent of the full flat benefit.

Prepared by Virginia Reno, Research Director and Kathryn Olson, Research Associate, of the Academy staff. ■