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Experts Agree on Economics, Differ on Values and Politics of Privatizing Social Security

As the new Congress and the administration prepare to deal with Social Security solvency, the Academy's blue-ribbon panel of scholars sheds light on two major approaches being considered. One would keep the current Social Security defined-benefit structure, but build and maintain a larger trust fund and invest part of it in stocks and corporate bonds. The other would set up individual Social Security savings accounts, also invested in private markets.

The panel agreed that it is advance funding of Social Security, not setting up individual accounts, that improves its future financing, raises national savings and increases money's worth for retirees in the distant future. It also agreed that individual accounts would have higher administrative costs and expose workers to more market risks, but it disagreed about the desirability of individual accounts. The panel chaired by Peter Diamond of MIT issued its report, *Evaluating Issues in Privatizing Social Security* in November.

The Solvency Problem

Social Security is running excesses of income over outgo in the near term, but it is not in balance over the next 75 years. In 1998, it received about $435 billion in taxes plus $49 billion in interest, and paid $383 billion in benefits and administrative costs, thereby adding $100 billion to trust fund reserves. The Social Security Trustees project that starting in 2013 taxes will be less than benefits, but with interest income the reserves will continue to grow. In 2021, the reserves will begin to decline, and by 2032 they will be depleted. Revenue then would cover three quarters of benefits due.

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Academy to Issue Two Reports and Video for Medicare Commission's Finale

Medicare and the American Social Contract, to be released early this year, is the final report of the Academy's Study Panel on Medicare's Larger Social Role, chaired by Rosemary Stevens of the University of Pennsylvania. The group met over two years and developed its answers to the questions: Why was Medicare created? What risks was it designed to mitigate? Is its current structure still the best way to address these risks for the next generation of beneficiaries? What criteria, rooted in the values and expectations of taxpayers and beneficiaries, can be used to evaluate alternative approaches to Medicare reform? How do various plans stack up?

To accompany *Medicare and the American Social Contract,* the Academy produced a 30 minute film, *Medicare Today and Tomorrow: Views from California.*

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More Funding, not individual accounts, brings economic benefits, says Panel

Key Findings

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The Panel considered three broad questions about new solvency proposals.

Should Social Security have more advance funding? Advance funding means raising taxes or lowering benefits in the near term in order to build up more funds to pay future benefits. This can be done in the traditional system or by setting up individual accounts. The panel favors advance funding, but members differ on how it should be done. The panel agreed on the economic effects of advance funding with regard to future financing, national savings and "money's worth."

Future financing. The panel agreed that advance funding (i.e., new revenues or benefit reductions in the near term) would reduce the need for tax increases or benefit reductions later because it would increase Social Security reserves and the investment returns on those reserved could help pay for future benefits.

National savings. The panel agreed that it is advance funding, not the creation of individual accounts *per se*, that adds to national savings, which, according to economic theory, would contribute to economic growth.

Money's worth. "Money's worth" refers to the average rate of return that an age cohort of workers can expect to receive on its lifetime Social Security taxes. The Panel agreed that it is advance funding, not the creation of individual accounts, that improves money's worth for retirees in the distant future. But the higher returns for future workers and retirees come at the expense of lower money's worth for people in the near term who pay the higher taxes or receive lower benefits.

"Advance funding, not the creation of individual accounts, improves money's worth in the distant future... but lowers returns for people in the near term who pay higher taxes or receive lower benefits"

Should Social Security funds be invested in the stock market? The panel concluded that the system would get better long-term returns with a diversified investment plan that includes stocks — and this is worth the risk — but it differed about whether this is better with or without individual accounts. The panel determined that an independent institution would be needed to prevent political interference in corporate affairs if investments were organized by the government. It suggested a model based on the federal employees' Thrift Savings Plan (TSP), which to date has avoided political interference.

Should Social Security include individual (defined-contribution) accounts, or should it stay with its traditional defined benefits? The panel was divided on this question. Its disagreements were about values and political predictions not economics. Proponents of individual accounts favor more individual choice and believe such accounts increase the chances that advance funding would be enacted and sustained without improper government involvement in the workings of corporations. Opponents of individual accounts favor the shared security of the collective system and believe that individual accounts will erode the security of benefits, particularly for low-paid workers, widowed and divorced spouses, disabled workers, children of deceased workers, and people who live a long time in retirement.

Despite value differences, the experts agreed on their economic analysis. They agreed that individual accounts would have higher administrative costs and expose workers to more market risks — both in fluctuations in the value of their accounts and the terms on which benefits would be paid at retirement.

The panel emphasized that comparing stock market returns with returns on Social Security

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Panel weighs costs of Social Security accounts

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taxes is comparing apples and oranges. Social Security returns and market returns are different because a large part of taxes must pay for benefits to current retirees, disabled workers and young survivor families, whether or not there are individual accounts.

The experts also agreed that, with any given level of advance funding and investments, the rate of return that workers receive on their Social Security taxes would be no higher with individual accounts than with traditional benefits. When administrative costs are subtracted, money's worth would be somewhat lower with individual accounts.

The panel outlined a low-cost, low-service plan for individual accounts that would be administered by the government as part of Social Security. It might cost about $25-$50 per participant per year to administer on top of the current system, which cost $16 per person, or $3.4 billion in 1997. A plan like this would minimize new burdens on employers and be less flexible and state-of-the-art than many large private plans. Minimizing employer burdens is important because Social Security covers many very small employers. Of the 6.5 million employers who report to Social Security, about 4 million have no more than 10 employees.

The panel noted that the more than 140 million workers covered by Social Security are far more diverse than those covered by private retirement plans. Many workers would need help in understanding a new savings plan in Social Security, the panel noted.

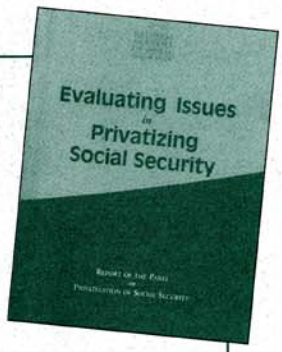
> ***"Comparing stock market returns with returns on Social Security taxes is comparing apples and oranges. A large part of taxes must pay for benefits to current retirees, disabled workers and young survivor families, whether or not there are individual accounts."***

Moreover, the 25 percent of American workers already in 401(k) plans are very different from the entire work force covered by Social Security. They tend to be higher-paid, full-time workers with at least 12 months' tenure on their jobs. Workers covered by Social Security, in contrast, include many low-paid, part-time and intermittent workers and many who hold more than one job. About 62 million workers covered under Social Security earn less than $15,000 a year, including 30 million who earn less than $5,000. Explaining a new system of Social Security accounts and enrolling workers in it would be an important part of setting it up.

The panel emphasized that implementation costs should be evaluated consistently across plans. To that end, it developed a summary list of new administrative tasks that would be necessary in government-organized individual accounts, and the additional new tasks that would be involved with privately-organized accounts.

The panel was not asked to analyze traditional ways to balance Social Security — such as combinations of gradual benefit reductions or revenue increases — because they do not raise complex, new analytic issues.

The work of this study panel was supported by the Alfred P. Sloan Foundation, the AARP Andrus Foundation, The Actuarial Foundation, and TIAA-CREF.
The full report is available on the Academy's website, **www.nasi.org**, and can be ordered from the Academy, 202-452-8097. ■



Evaluating Issues in Privatizing Social Security, Peter A. Diamond, editor. Final Report of the Panel on Privatization of Social Security. 90 pages, $18.

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