

# **Positioning Pensions for the Twenty-First Century**

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## Chapter 12

# Reforming Social Security?

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Edward M. Gramlich

Like many other public pay-as-you-go (PAYG) systems, the United States Social Security system is running into long-run financial difficulties. Workers are now living long past their retirement age, fertility rates are below the zero-population-growth level, and long-term rates of real wage growth are at a historically low level. These difficulties are reflected in the recent Report of the Social Security Trustees (1996) that implied that significant austerity measures will be necessary to restore long-run balance in the system. Moreover, cohort rates of return on payroll contributions are declining to levels well below going real interest rates for young people. Polls indicate that increasing numbers of young people do not trust that Social Security benefits will be there for their own retirement (Friedland 1994).

As with other PAYG systems, Social Security and disability benefits are paid by trust funds that have time-related schedules (i.e., future benefit liabilities can be predicted from present tax payments). Every year the Trustees of the system (the Commissioner of Social Security, three cabinet members, and two outside members) report on the long-run actuarial soundness of the system, and every four years an outside Advisory Council (such as the one I chaired from 1994 to 96) is established to review the methods and assumptions of the Trustees as well as to suggest new policy departures. These bodies have developed the tradition of requiring the system to be in "close actuarial balance" over a 75-year period, though it would make perfect sense to go to an even longer planning horizon. In 1994 the Congress passed new legislation to make the Social Security Administration an independent agency, and one of the provisions of this legislation would create a permanent advisory body that will presumably develop its own long-term actuarial conventions.

In their 1996 report the Trustees confirmed again a proposition that is becoming increasingly familiar to Americans—rather than being in

close actuarial balance for a 75-year period, the old age, survivors, and disability trusts funds are in close actuarial balance for only 35 years, under an intermediate set of assumptions regarding births, deaths, labor force participation, real interest rates, and real wage growth. Under these assumptions, the trust funds are accumulating assets now, that is, they are running a current account surplus, but the assets rapidly deplete and the net worth of the trust funds drops to zero by about year 2030. By this time fund outflows are expected to be running well ahead of inflows, so major changes would have to be made to bring the system back into close actuarial balance for a 75-year period. Even more significant changes would be necessary to bring the system into close actuarial balance in perpetuity. This chapter reviews briefly what some of these changes might be.

### **Incremental Change Options**

Logically, any incremental change options must be either on the benefits side or the tax side. I first discuss some benefit and tax changes within the present system and then some more radical options for changing the system.

#### *Raising the Retirement Age*

The measure that first occurs to most people is to raise the normal retirement age. When Social Security first began in the 1930s, the normal male life expectancy at age 65 was 12 years. It is now 15 years and slated to rise to 18 years over the forecast horizon. Given this rise, and the fact that most workers are less likely to have had physically demanding work histories than in the 1930s, it might seem logical to raise the normal retirement age for payment of benefits above its present level of 65 years of age (and slated to rise gradually toward 67 beginning in year 2000 due to previous austerity reforms).

Although there are strong arguments for considering further rises in the retirement age, there are also some drawbacks. For one thing, not all workers now have easy jobs; some are still physically spent by age 65. For another, rises in the normal retirement age may have different effects on different racial groups, depending on their life expectancies. For a third, the fact that life expectancy at retirement has increased does not necessarily mean that retiree health has; the three added years on a retiree's life may be three years of relatively poor health for some individuals. But the biggest problem with raising the normal retirement age is that, because of the way benefits are computed, in the end this is nothing but an across-the-board cut in Social Security retirement benefits. Given the

generally low level of these benefits already, and the fact that this low level already leaves many aged individuals in poverty status, there may be a better rationale for selective, not general, cuts in benefits.

### Other Cuts in Benefits

There are many other ways of cutting benefits, as compared to present law. An across-the-board measure often suggested by legislators hoping for quick cuts in budget deficits is to delay or suspend the price indexing of benefits. One problem here is that the fact that a key value of Social Security lies in its protection against inflation. Suspension of price indexing, for any group of people or any time period, debases this value. Another problem, as already noted, is that for many people Social Security benefits are not very high, and even brief suspensions of indexing will throw many aged people into poverty status.

An approach suggested in the deficit-reduction plan of a group known as the Concord Coalition is to means-test current benefits (i.e., reduce benefits for high income retirees). While there eventually may be a need to scale back benefits for high income people, there are other ways of doing this that seem much more consistent with the underlying logic of Social Security than simple means-testing. One is to alter the benefit formula gradually over time so that high income replacement rates are lower. Another is to make benefits completely taxable within the general income tax, using either consumption or income tax principles.

There might also be a mixed strategy for scaling back benefits. One such package might consist of more complete taxation of all Social Security benefits, further increases in the retirement age, and further gradual reductions in high income replacement rates through the benefit formula.

### Raising Payroll Taxes

The great unmentionable in American politics is the T word—should there be rises in taxes? Tax increases could be designed that would restore the close actuarial balance of the system, and they could be nicely delayed for ten or twenty years so as not to cause grief to present-day politicians. Should they be part of the actuarial balance rescue package?

One objection to the present payroll tax is that for high incomes the tax is regressive. It is assessed only on the first US \$61,000 of annual wages, at the 87th percentile of the wage distribution. This regressivity could be partially corrected by simply removing the taxable ceiling, as has already been done for the health insurance component of the payroll tax. While this change would reduce the regressivity of the payroll

tax, it would not eliminate all regressivity because much of the income of high income people does not come in wage form, a change that would bring in limited net revenue over the very long run unless the benefit schedule were flattened at the high end.

The other possibility is simply to raise the payroll tax rate. Adverse affects on economic competitiveness are probably modest due to the presumed inelasticity of overall labor supply and the fact that general payroll taxes are probably shifted back onto labor. But the real problem with this type of change, and also with all of the benefit reductions discussed above, involves an issue not yet raised that is likely to become increasingly important over time—rates of return.

By comparing payroll employer and employee taxes and subsequent benefits, it is possible to compute internal rates of return for different age cohorts from the Social Security system. For cohorts born in 1875, who paid in next to nothing and received benefits, annual real rates of return were on the order of 35 percent, better than almost any imaginable investment. For cohorts born in 1900, annual real rates of return were about 10 percent, and for cohorts born in 1925, about 5 percent, still well above the going real interest rate in the economy (approximately 3 percent). For cohorts born in 1950, roughly the beginning of the baby boom generation, rates of return are down to 2 percent, now below the going real interest rate, and they continue to drop slowly. These are real rates of return for the whole cohort. But as was pointed out above, because of the progressivity of the Social Security system, rich people of a cohort get a lower internal rate of return than the cohort as a whole (with constant life expectancies). For these relatively well-off young people, the internal rate of return is on the order of 1 percent or lower.

There are basically three reasons for this drop in rates of return. First, any PAYG system will experience rate of return drops as the system matures; those retired at the time the system starts get benefits without paying in and get infinite rates of return. Rates of return then drop asymptotically toward the rate of growth of real wages plus population growth, the equilibrium real rate of return in a PAYG system (Samuelson 1958). That suggests the other two reasons for the drop in rates of return. The second is that, because of the drop in national saving and other economic factors, overall productivity growth and the rate of growth of real wages has slowed in the United States. This rate of growth of real wages is projected to be only 1 percent per year, and even that low rate is above that experienced for the past two decades. The third reason is demographics. For the first time since the US Social Security system began, a cohort (the baby boom generation) was larger than the following cohort. But by now fertility rates are low enough that every cohort is

predicted to be larger than its following cohort, at least apart from new immigration. Thus there are always likely to be relatively few workers paying the retirement costs of relatively more workers, or, in Samuelsonian terms, the equilibrium real rate of return on workers' Social Security contributions will be 1 percent or less.

Until now Social Security has been a uniquely popular public program. Poll after poll has recorded this popularity, and an important reason to maintain the generality of Social Security is to preserve its popularity. It is one public system that everybody is a part of, and the sheer accomplishment of paying out this much in benefits for this long a time should not be denigrated. But looked at in cold, calculating terms, any program that gives people 10 percent real rates of return should be pretty popular. What happens when the real rate of return drops to 1 percent or below, as it is bound to with further payroll tax increases or benefit cuts? Friedland (1994) already reports that young people seem to have much less interest in Social Security than their elders, commonly reporting that "there will be nothing there for me." There may be something there for young people, but if the internal rate of return is less than 1 percent, these same people can be excused for asking "just how much?"

This political popularity point, much more than economic distortions, seems to be the main argument against tax increases. They load costs even more on young people, who are already getting a low implicit rate of return on their tax payments. It is also a reason for going slow on reductions in benefits to high income individuals, which raise the same rate of return questions. But if tax increases and high income benefit cuts are ruled out for political reasons, how exactly does the nation restore actuarial balance in the system? There are not many obvious alternatives other than altering the way funds for retirement income are saved and invested.

## **Fundamental Changes**

One possible answer to the question of how to make austerity cuts but still keep well-off young people feeling they have a stake in Social Security is to give these young people new pension saving opportunities, either collectively or individually. Macroeconomists generally agree that the United States economy is now undersaving. Were there added pension saving, it could be invested at the world real interest rate of about 3 percent. While one could not fight the fact that well-off young people received only 1 percent real return on their Social Security payroll taxes, these same young people could do much better on their whole retirement portfolio.

In addition to this macroeconomic rationale, there is also a microeconomic rationale for such a change. There are grounds for believing that the present US tax and retirement system unduly limits private pension saving. It is now possible to do some pension saving in the US tax code under consumption tax treatment, but there are tight limits on these possibilities. Recent income tax law changes have also discouraged pension saving in defined benefits plans (Committee for Economic Development 1995). Overall, it is estimated that the typical worker would need to save 18 percent of wages annually to provide for 50 percent replacement of income in retirement years (Schieber 1995; Cutler 1995). The typical worker in the United States now saves at rates well below 18 percent, even when including the 10.7 percent (12.4 percent including disability) of wages now paid in the form of Social Security retirement taxes.

There are two ways of capturing the gains from added national saving, one primarily a public or collective approach and one primarily a private or individual approach.

### Higher Public Pension Saving

The most straightforward public way to raise national saving was proposed by Aaron, Bosworth, and Burtless (ABB 1989). They argue for prefunding the rise in future benefit payments by raising payroll taxes now and investing the proceeds in government bonds, as the system now does. A more radical variant of this approach was recently suggested by one of the ABB team, Bosworth (1995). Under his new approach, payroll taxes would again be raised now, though by less than in the ABB proposal, but instead of investing the funds in government bonds, Bosworth would permit the Social Security trust fund to invest a portion of its assets in private equities, hence permitting the system to capture more of the benefits of the high rates of return on new saving. This approach would enable the Social Security system to take advantage of what economists call the "equity premium puzzle," the fact that over long periods of time equities pay substantially more than bonds, even with generous adjustments for portfolio risk (Congressional Budget Office 1994). Bosworth calculates that under realistic assumptions these changes alone would eliminate actuarial deficits for the foreseeable future, with only a 2 percentage point rise in payroll tax rates (from the present 12.4 percent to 14.4 percent).

Under either the ABB or the new Bosworth approach, it may be necessary to remove Social Security from the federal budget. As long as Social Security stays in the budget and deficit targets are imposed on the overall unified budget, it can almost be guaranteed that any added Social

Security saving will be offset by higher deficits elsewhere in the budget. This means that any added Social Security saving will not even raise federal government saving, let alone overall national saving, and that there will be no added national income to be used to solve the long-term difficulties of the Social Security system.

Under the new Bosworth approach it would also be important to regulate the investments of the new Social Security fund. One obvious reason is financial prudence; but there is another reason as well. Right now the Social Security fund is more than ten times as large as any other pension fund in the United States, and the disparity increases if Social Security payroll tax rates rise further. Given the size of this new pool of investment funds, and the possibility of it being used in a political way, it would be very important to neutralize the political impact of Social Security investment. There may be ways to do this, either by letting a number of competing fund managers do the investment or by having Social Security invest in broadly based index funds (Weaver 1994b), although this presents a formidable and perhaps unprecedented problem in financial politics.

### Higher Private Pension Saving

The private approach features a variant of the dual pillar system that the World Bank, among others, has been advocating (World Bank 1994; Weaver 1994a). In a gradualist version of the dual pillar approach, future Social Security benefits for young, high income people might be scaled back, and then supplemented by mandatory defined contribution individual accounts layered on top of the Social Security system.

These individual accounts could be held inside or outside Social Security, with the individuals who own them given constrained choices about investing the accounts in index stock funds or index bond funds. Again overall pension saving is supplemented by new national saving, again invested at the going market rate of return for stocks or bonds. This time, since the investment is through the individual accounts, there would be no particular fear of government political control of large investment funds. Particular individuals or firms would choose their own funds managers, and these management decisions would be sufficiently diversified to eliminate most political control problems.

But there could be some other fears. One is the need to insure the safety of these individual accounts, both in terms of how the funds were invested and how the annuities were regulated. Another is the fear that, as high income people rely more and more on their individual accounts and less and less on Social Security proper, Social Security becomes more

of a redistribution program and less of a communitarian program. This too could threaten the unique political popularity of the Social Security system.

It is also possible, however, to imagine an intermediate reform that still raises national saving, along the lines recently proposed by the Bipartisan Commission on Entitlement and Tax Reform (1995). Instead of simply raising payroll tax rates, it might be possible to designate some of these added contributions as made on behalf of the individual, and to fold these contributions into the normal Social Security indexed annuity that is now payable on retirement. The investment of these individual accounts could be done by constraining choices to broad investment options, as the federal thrift plan now does. This intermediate option raises national saving without raising taxes and solves the investment difficulties associated with direct-fund investment in equities. Whether it sets to rest fears that the individualized component will dominate the public component of Social Security over time is quite difficult to determine. A different form of intermediate measure is to make the individualized accounts voluntary, perhaps related to or constrained by the amount of benefit cuts certain individuals received.

However these issues play out, the underlying feature of all of these options is that there must be added national saving. This saving can be invested at attractive rates of return, and these returns can be used to raise overall national living standards and simultaneously to supplement pension income and ward off the looming financial difficulties amply documented in the Trustees' Report. This saving could be done collectively by the Social Security system, individually, or individually within the Social Security system. There are advantages and disadvantages of each approach, but the national saving does have to be added. Without this, society's living standards are no higher, and any greater returns from equity investment are only a form of higher Social Security tax on the rest of the economy (Congressional Budget Office 1994).

## **Implications**

The US Social Security system has served remarkably well for a 60-year period in providing retirement income for hundreds of millions of people and in maintaining a high degree of political popularity. It should not be changed quickly or without careful planning. At the same time, some of the early assumptions on which the system was built are now changing: retirees are living longer, cohort sizes are stable or declining, and, most significantly, rates of national saving and productivity growth have dropped sharply. All of these changes are leading to drops in the internal

rate of return on Social Security contributions to levels well below going real interest rates. The combination of these changes and other forces has led to a considerable reduction in the long-term actuarial health of the system, requiring some package of significant cuts in benefits and/or payroll tax increases.

These cuts or increases may be difficult to accomplish in a way that preserves the historical popularity of the Social Security system. There might be several ways of breaking the impasse, from fine-tuning the present system to new approaches for saving and investing retirement funds. All approaches have their advantages and disadvantages, but it is generally true that the greater the level of new saving and the greater the ability of the system to invest safely in equities, the less are austerity cuts in benefits necessary and the higher are the overall rates of return on pension saving for younger people.

Opinions are the author's and should not be attributed either to the Advisory Panel or the Social Security Administration.

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