

Social Security: The Challenge of Financing
the Baby-Boom's Retirement

by

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The post-World War II baby boom has left its mark on the American economy in many ways. Nurseries and schools bulged beyond capacity. The labor market could not absorb new entrants without high unemployment and disappointing productivity growth. The relative price of housing soared. And, now, yet another challenge looms: this time for Social Security, as the leading edge of the baby boom starts to approach retirement.

Longevity poses a challenge of its own. Thanks to modern medicine, more people live to retirement age, and they live longer as retirees. An unprecedentedly low ratio of workers to Social Security beneficiaries -- the product of these forces and of the drop in the nation's birth rate after the mid-1960s -- thus lies ahead. The ratio is projected to fall to 2.0 to 1 in thirty years' time, down from 3.2 to 1 today and from as high as 4.0 to 1 thirty years ago.

How the demographic challenge is met will profoundly affect not only the Social Security System but the broader budget outcome and the economy at large. Already, Social Security -- understood here to encompass the Old Age (OA), Survivors (S), and Disability (D), but not the Health (H), Insurance (I) parts of OASDHI -- accounts for 22% of federal spending and 5% of GDP. Within the next several decades, the percentages could easily rise by one-third, and perhaps as much as half.

To be sure, projections that long into the future must have a wide berth. Two things are clear, however. First, tabloidesque characterizations of Social Security's "going broke" are out of place. The System can maintain benefits for more than 30 years at current tax rates, to judge by the base-case assumptions in the last annual report of its trustees (Social Security Administration 1996a). Second, not all of Social Security's promises are sacrosanct; the nation cannot make good on all of them in the longer run without significantly higher payroll taxes (Steurele and Bakija 1994). By 2030, the trustees' project, only three-

quarters of benefits can be maintained at current tax rates. And by as early as 2010, benefits will exceed taxes. For a time thereafter, reserves (which are held in the form of Treasury securities) will remain on the rise as interest income on past reserves continues to accrue. But reserves will grow less rapidly than before, and subsequently start to decline as benefits continue to exceed taxes (accompanying charts). All of this will require difficult and explicit trade-offs not only for Social Security but for the federal government at large. And hard decisions will also have to be made if, while they are at it, policymakers attempt to improve the equity and efficiency of the System, which also are in need of repair.

Serious national dialogue, if not debate, about those trade-offs should have begun long ago. The demographics and their implications, after all, are hardly “new news.” That dialogue has been tabled time and again -- the last time during the 1996 presidential campaign -- in deference to Social Security’s status as an untouchable, if not “third rail,” program. In the future, though, timidity in dealing with the System’s long-term financial imbalance is apt to be similarly costly politically. Increasingly, polling data indicate, the public is aware of that imbalance. It can be expected to grow impatient with continued deference to third-rail thinking to justify inaction.

Social Security’s appeal over the years has been grounded in the fact that almost all of its beneficiaries, albeit to varying degree, have been “winners.” Almost all have been in a position to secure a retirement annuity significantly greater in present value than the value of the payroll taxes they and their employers jointly “contributed” during their working lives -- and at the same time to protect their families financially in the event of their death or disability before retirement age. Setting benefits on the basis of prevailing wages rather than on the basis of taxes paid, in combination with secular growth in the economy, almost guaranteed that outcome.

Social Security no longer can offer such a guarantee. Given the demographics, the System cannot serve the interests of young workers as much as it did their forebears’. The challenge to Social Security is

thus twofold, if not Catch-22: to bring the System into long-run financial balance while preserving its popularity. A broader challenge has to be met as well: to set a course for Social Security that itself is in balance with the other obligations of government. Support of the elderly and the near-elderly under Social Security and public health care programs already requires an overall tax rate approaching 10% of GDP; it can only go up from there, quite possibly even doubling within the next few decades. Government's ability to meet its other obligations will be in question even more than it is now.

Differing models for the future

One of two competing visions of Social Security's future would keep the System much as it is today, but tailor benefit formulas and taxation to new needs, as was done on several occasions in the past. The other would "privatize" it, grafting onto it a defined-contribution plan much like a 401(k), while shrinking its public benefits. Reduced to their essence, these are the main lines of the competing approaches sketched out in the report of the advisory council released earlier this year (1994-1996 Advisory Council on Social Security 1997).

Six of the 13 council members put forth a plan of reductions in benefits and increases in taxes on benefits, which would eliminate about two-thirds of the long-run actuarial imbalance. They also would have policymakers consider investing System reserves (which as the chart on System assets shows are projected to grow handsomely in the next ten years or so) in the stock market in order to capture the market's returns, which over the long run have greatly outstripped those on the special-issue Treasury securities that the System's reserves are now automatically invested in. Investment in the stock market (on the premise that its relatively high returns will carry over into the future) would right the other one-third of the long-run financial imbalance, thereby limiting the program changes that otherwise would be needed.

Investing reserves in equities would be a major change for federal finance as a whole, as it would force the Treasury to find private

investors for the federal debt not then purchased by the trust funds. But it would not be a departure for Social Security itself. All of the risk of the System's new investment strategy would be borne publicly, and the defined-benefits character of the program would be maintained -- hence the label "Maintenance of Benefits" for the plan put forth by the six council members. From the perspective of both the pensioner and the taxpayer, nothing would have changed.

The privatization alternative -- which would give workers the option of dedicating five percentage points of the current 12.4% OASDI tax rate on covered earnings (this year, a maximum of \$65,400) to individually managed Personal Security Accounts -- was supported by five council members (1994-1996 Advisory Council on Social Security 1997). Although such investment would operate under government strictures (governing, for example, withdrawal of funds before retirement age), the privatized assets would be owned by the individual, and could therefore be passed on to heirs. Another two council members, among them council chairman Edward M. Gramlich, advocated a smaller, but conceptually similar, saving and investment plan, to be funded by a tax of 1.6 percentage points on top of the 12.4%.¹

Nature of the choice

This paper compares and contrasts the two visions of Social Security's future. Its object is to give readers the background they need to understand the arguments made by the two sides, and thus to follow the debate that promises to unfold at the national level in the next few years -- first perhaps in the confines of a presidential commission and later in Congress and the political arena at large. There is no mistaking what is at stake: a choice between pay-as-you-go and advance funding; between social and personal risk; between a defined-benefit and a defined-contribution plan. At the outside, the choice is between a communitarian and an individualistic approach to the economic security of the elderly.

¹ Like the Personal Security Accounts plan, the Gramlich plan moves Social Security in the direction of defined contribution, although the two plans differ in many of their particulars.

If Social Security were to be designed from the ground up, the ideal approach may well not be today's program, which has its roots in the economic collapse and the widespread financial insecurity of the 1930s. The task ahead, however, is to make changes in existing institutions, taking into account their history and their effect on the financial planning and decision-making of individual citizens. And it is to make changes for which a consensus can be reached and translated into legislation.

On balance, the conclusion is, the nation would be better off keeping Social Security much as it is today. If that is the choice, however, additional tax incentives to promote saving are in order. They would make for faster growth of the capital stock and productivity, and thus ease the transfer of income from a relatively small to a relatively large generation. Savings incentives would also help to soften the inevitably unpopular measures that will be needed to right Social Security's long-term financial imbalance.

Financing Medicare and other publicly financed health programs for the elderly poses another, even larger, challenge. That is outside the scope of this paper. Policy decisions with respect to OASDI can be made on their own merits, as can those in the area of health care. Indeed, that is implicit in the separate trust funds set up for OASI, DI, and HI and in the different payroll taxes that finance HI and OASDI. It must be kept in mind, however, that the demographic forces at work in Social Security retirement are among those at work in the health care programs as well. The beneficiaries, moreover, are largely the same. And, not least, they draw resources from a common pool.

I. Social Security: structure and function

In order to evaluate the alternative approaches, it is important to understand how benefits are structured, how Social Security transfers income within and across generations, and how the System affects the broader budget outcome.

Benefits are set by lifetime earnings, adjusted to reflect earnings prevailing in the economy at large -- not set, as myth would have it, by taxes paid. The "I paid into it" thinking that inevitably came about with payroll tax financing fostered the "bank account" model. And so did the political establishment, which did not want the cost of any largesse on the benefits side to be apparent to taxpayers, who were encouraged to view their payroll taxes as saving for the own retirement. It was, moreover, expedient to disguise the unusually large benefits accruing to the first generation of beneficiaries, which unlike those who came after them had not paid payroll taxes most of their adult lives.

While the System is now building reserves, it is still largely pay-as-you-go. And it was entirely pay-as-you-go through the late 1980s. Each generation, in effect, pays for the retirement of its parents, and, in turn, is supported by its children -- the essence of a tax and transfer system operating across generations. The parents and children in question are writ large, to be sure, but the underlying reality is that of the traditional family (Mehrling 1996). The income of the elderly depends not on the income and the productivity of their own children, who in the traditional family model would assume the provider role -- sometimes successfully and sometimes not. Instead, their income depends on the productivity of the next generation as a whole, which in a growing economy guarantees the younger generation's success as provider.

From the point of view of the family model, today's emphasis on money's worth calculations -- in the advisory council's report as in other forums for debating Social Security's future -- is overdone. Social Security is not, and never was, a saving and investment plan; rather, it is, and always was, a way of supporting one's elderly parents (here, writ small) with income that would have to be provided in most, even if not in all, cases. It is as hard to make reliable money's worth calculations for Social Security as it is to estimate the returns to be derived from paying an aged parent's rent bill. Viewed in this way, the

unearned benefits accruing to Social Security's first generation were not so large after all.

Calculating benefits

Benefits are progressive, i.e., they are high relative to the lifetime earnings of low-income workers, low relative to the earnings of high-income workers -- thus countering the regressivity that is characteristic of a flat payroll tax rate figured on earnings up to a ceiling. The object is to provide a base level of support -- not to maintain in retirement the incomes of high-income workers who ordinarily have ample personal and employment-linked retirement resources. Whether those resources are, in fact, ample cannot be a matter of public policy concern.

Benefits are keyed to prevailing wages just before retirement -- thus allowing retirees, at least initially, to capture the growth in productivity and thus in real earnings that came about during their working lives. Only initial benefits are linked to prevailing wages, however. After retirement, benefits are escalated by inflation, measured by the previous year's rise in the consumer price index (CPI). But they do not increase with real earnings. They keep up with inflation, but not with general living standards.

The calculations for new retirees start with the history of their earnings at age 60. The earnings for each year, up to the taxable wage base for that year, are multiplied by an index factor that reflects the subsequent growth in economy-wide wages. The resulting series (with earnings after age 60 indexed at a value of one) thus captures what workers would have earned each year had they been working in today's environment of relatively high productivity rather than in the past (accompanying table). From the time series of indexed earnings, the highest 35 years are averaged (and then divided by 12) to compute Average Indexed Monthly Earnings (AIME).

The next step is to compute the Primary Insurance Amount (PIA), which is what the worker will receive each month at retirement if he or

she retires at the normal retirement age of 65. This is calculated by dividing the AIME into three parts, multiplying each of them by successively lower percentages, and summing the resulting dollar amounts. The sum is of: 90% of \$422, the first "bend point" for 1994, which is when someone now age 65 turned 62; 32% of the next \$2,123, and 15% of the amount in excess of \$2,545. The PIA is then adjusted for retirement age within the range of minus 20% (for those retiring as early as age 62) to plus 25% (for those willing to wait until age 70). These percentages are slated to change slightly in the future to provide a premium of 8% per year for postponing retirement -- the object being to structure an age-neutral annuity for those retiring at age 62, 70, or at any age in between. The actuarially fair value of lifetime benefits will be the same for all -- theoretically rendering the normal retirement age of 65 (or 67 as current law would have it rise to over time) almost meaningless.

A "spousal benefit," equal to 50% of the retiring worker's PIA, is also factored in, even if the spouse never worked. A two-wage earner couple both receive benefits in their own right. But, at a minimum, the lower-earner of the two is entitled to the spousal benefit attaching to the higher-earner's pension. Benefits formulas thus favor couples with widely disparate earnings -- at the extreme, one-earner couples, no surprise considering the System's roots in the 1930s. Not only was the labor force participation rate of women far below today's. There were not enough jobs to go around, the depression-era experience seemed to make plain. Hence a relatively high spousal benefit, which as a practical matter favored high-income workers whose wives, until the 1970s in any case, tended to be out of the labor force more than women generally. Low ceilings on the wages (\$13,500 currently) that can be earned while drawing full retirement benefits -- which, the theory was in the 1930s, free up jobs for younger workers -- also reflect the widespread joblessness of the Great Depression.

The bend points, as well as the AIME, are indexed to prevailing wages. The formulas thus are designed to have average real benefits for successive cohorts of new retirees increase at roughly the same rate as economy-wide wages. The object is to keep replacement rates

constant over time, that is, to have initial pensions replace a constant share of earnings just before retirement. The object also is to keep replacement rates constant between one income group and another in every retiring cohort (this comes about because the percentages applying to the AIME amounts below each bend point are fixed). Successively lower percentages at each bend points provide the progressivity. And so do formulas for minimum benefits, which are provided those who have been employed for as little as 40 quarters.

Pattern of replacement rates

Replacement rates (the percentage of earnings just before retirement that Social Security replaces) are higher today than the historical norm for the majority of retirees (Steuerle and Bakija 1994). But they are in line with outcomes under benefits formulas set out as early as 1939 (Myers 1993). For single-workers at age 65, for example, Social Security replaces about 53% of pre-retirement earnings for those at low wages; about 40% for those at average wages. For high-wage workers, in contrast, today's replacement rates are below the historical norm. They are in the neighborhood of 26% for those whose pre-retirement earnings were close to the maximum wage base (replacement rates decline beyond that base, since only earnings below the base are included in calculating benefits).²

Replacement rates today cluster in the range of 10 to 30 percentage points higher than in the early 1950s. At the time, Social Security had failed to keep up with the wartime and postwar rise in the price level, absent adjustment mechanisms that would have seemed unnecessary in the deflationary 1930s.

Legislation enacted in 1950 was designed to correct that oversight. But, along with ad hoc changes made in ensuing years, the net effect was to lift real benefits not only for new retirees but for beneficiaries at large -- including the disabled, who were included for the first time in

² After-tax replacement rates are higher for low- and average-wage workers, since for the most part their Social Security benefits are not taxed.

1956. A virtual bidding war to raise benefits (which at the time were not indexed to inflation but set by individual pieces of legislation) marked American politics in the early 1960s and early 1970s. Benefits rose an extraordinary 72% in the five-year period ended 1972; real benefits, by nearly half (the CPI in that five-year period increased 28%). All the while, the ratio of workers to retirees, even if high by today's standards, was on the decline.

Replacement rates came down from the peaks they reached in the mid-1970s, as a flaw introduced into the calculation of benefits in 1972 was soon corrected. The bidding war also came to an end with the automatic escalation of benefits to the CPI adopted at the same time. Even so, Social Security outlays had risen roughly ten times as rapidly as nominal GDP between the early 1950s and the early 1980s. Tax rates had more than tripled, applied against a wage base that relative to prevailing wages had also risen threefold-plus.

Watershed 1983

Payroll taxes took another jump in 1983 when increases in tax rates legislated in the 1970s were moved forward in order to deal with a looming liquidity problem. OASDI taxes rose in a series of steps from 10.8% of covered payroll (employer and employee combined) in 1983 to the current rate of 12.4% by 1990. Benefits were reduced at the same time -- principally by raising the normal retirement age and by making some of them taxable (taxing benefits is tantamount to reducing them). The normal retirement age was slated to rise gradually, beginning in 2003, to age 67 by 2027. Currently, 85% of benefits are taxable on a joint return when the adjusted gross income exceeds \$32,000, an amount that is not inflation-indexed and thus declines in real terms over time.³

³ Strictly speaking, the taxation of benefits did not add to OASDI reserves, since the income taxes paid on Social Security benefits are credited to the HI trust fund. It did, however, ease the broader deficit problem. And it probably kept payroll taxes overall from going even higher.

The effect of the 1983 changes, even if not the intention, was to build reserves in a period of demographic calm, which could be drawn down later when the baby-boom generation actually retired. In a pay-as-you-go system, reserves have no place. But they can play a useful role by smoothing the pattern of taxes over time. In effect, the baby-boom generation was to finance not just the retirement of their parents but, through the accumulation of reserves, part of their own as well.

The reserves are now cumulating at an annual rate of \$76 billion; they are projected to grow to \$1.3 trillion in constant 1995 dollars by the peak year 2015 (Social Security Administration 1996a). Automatically invested in Treasury issues, Social Security's surplus financed almost 40% of the deficit of \$173 billion in the rest of the budget in fiscal year 1996; the OASDI trust funds hold just over 10% of gross federal debt.⁴

Critics of these arrangements view the trust funds (and therefore the reserves held in the form of Treasury securities) as a fiction. They view the funds as holding not real securities, but merely IOUs of the Treasury generated by deficit financing itself. To make good on those IOUs, the concern is, Washington must raise taxes, cut spending, or float more debt in private markets. Those IOUs, however, are not essentially different from the Treasuries held by private pension funds or individual investors for their own account: not marketable perhaps, but just as "full faith and credit." They have solid backing in the form of the nation's political will to support the elderly, whether by payroll taxes or other means, and the economic ability to do so (Eisner 1996).

However wide apart in perspective, the two views are similar in implication. Not all that far ahead, Social Security not only will be unable to finance a large part of the rest of the budget, it also will have to lay claim to non-Social Security tax sources. As noted, benefits are projected to exceed payroll taxes by 2010; other revenue will have to supplement payroll taxes in order for the System to pay full benefits for the subsequent 20 years -- a time when it will, first, have to draw on

⁴ Technically, Social Security is considered off-budget, but its surplus or deficit is counted against budget targets.

the interest on the Treasuries now cumulating in the trust funds and, later, consume the principal as well.

The critical date for Social Security, narrowly considered, is as far off as 2030. But, for the budget at large, it looms as early as 2010. Thereafter, Social Security benefits can be maintained at current tax rates, but only if, in some combination, federal borrowing from the public rises, spending for other federal activities is cut, and taxes are raised. The challenge the nation faces not only is to right Social Security's long-run financial imbalance, it also is to find the revenue to repay the System for the large net lending it will have done for several decades.

Typology of System subsidies

With Social Security taxes rising sharply after 1983, on top of similarly sharp increases in the 1970s, it no longer is possible for all participants to be winners. Steuerle and Bakija (1994) have calculated the present or annuity value, in constant dollars, of OASI net income transfers for 23 age cohorts, by family type (e.g., married, one earner) and by lifetime income level, retiring at five-year intervals between 1940 and 2050.⁵ Such a measure captures the redistributive character of the System, not only across generations but also within them. The findings go a long way to explain why Social Security has been immensely popular over the years -- and why skepticism, if not cynicism, is growing among young workers. The key findings:

- Most retirees thus far have secured positive net income transfers -- that is, amounts in excess of the payroll taxes they and their employers paid in, plus a reasonable rate of return. But the dollar amounts of the transfers to high earners have been the highest, as they have been figured on a high base. Thanks to progressive benefits formulas, low earners have received the largest percentage return. But this has been on a relatively small base.

⁵ Disability benefits were not included in the analysis because of the paucity of detailed data on recipients of past benefits and the uncertainty about future benefits.

- The largest net transfers have gone to those retiring in the early 1980s. High-income, one-earner, families that drew a pension beginning in 1980, for example, received a net subsidy whose annuity value in today's purchasing power was close to \$200,000. These families benefited from the bidding war of the 1970s, but they had paid pre-bidding war taxes for most of their working life. And they did not get hit by the post-1983 tax hikes.
- Net subsidies will continue to decline in the future. They have already turned negative for high-income single people (the major exception to the winner rule thus far). They will become negative for high-income, two-earner, couples around the year 2000.
- Many nevertheless will continue to receive net transfers under today's benefits formulas (even if significantly less than their parents and grandparents did): in particular, one-earner couples, because of spousal benefits, and two-earner couples at low- and average-income levels, because of the progressivity built into benefit formulas.

In all, progressivity will be a greatly more important consideration in shaping benefits as the baby boom retires. Short of another jump in payroll taxes, net subsidies cannot be extended to the vast majority of beneficiaries. Any plan to correct Social Security's financial imbalance must recognize these realities.

II. Option 1: Working within the current framework

Actuaries at the Social Security Administration have estimated that financial balance over the long-run forecast period of 75 years requires that, effective immediately, benefits be reduced or payroll taxes raised by 2.19% of taxable payroll (Social Security Administration 1996a).⁶

⁶ The 2.19% is the difference between the 75-year cost rate and income rate, based on the intermediate assumptions for wages, interest rates, life expectancy, and other key variables. High-cost assumptions generate an imbalance as large as 5.67%; the low-cost assumptions, a surplus of 0.46%.

As with any long-term estimate, the figure will have to be revised as time passes.⁷ It nevertheless serves as a useful standard against which specific proposals can be compared. Measures that would not cut much into the 2.19%, and that nevertheless are apt to be highly objectionable to the public, are thus easy to rule out. Those that would either offer large savings, or promise relatively little outcry, are similarly easy to keep in the running.

However differing in their basic approaches, advisory council members who would keep Social Security much as it is today and those who would privatize it were in accord in counseling against increases in payroll taxes to close even part of the 2.19% gap. With money's worth calculations for young workers turning unfavorable, the council was united by concern that raising payroll taxes further would compromise the individual-equity principle on which the System was founded.

Cuts in benefits that affect retirees and workers alike (and workers well up in years as well as the young) thus dominate in the proposals advanced by the Maintenance of Benefits group.⁸ Those proposals, which are summarized below, would reduce the long-term deficit by about 1.40 percentage points -- leaving some 0.80 percentage points to be eliminated by other, as yet unspecified, benefits or tax measures, or by investment of reserves in the stock market if that approach makes sense on further inspection (1994-1996 Advisory Council on Social Security 1997).

- *Cover all state and local government employees (which would reduce the long-term deficit an estimated 0.22 percentage points). Almost four million state and local government employees (about*

⁷ Projections based on the 1983 reforms, which were also for long-term financial balance, have gone far off course in the intervening years for several reasons. Among the most important: The simple passage of time puts the System into greater deficit (surplus years near term get replaced by deficit years further out in time); the economic assumptions for such things as real wages were lowered; disability payments turned out to be considerably higher than expected. The time problem remains. But past estimating errors are no indication that today's projections will also go far off course.

⁸ Most of the group lined up behind increasing payroll taxes as well, but not until near the middle of the next century. As the 75-year period for financial balance moves ahead, it will capture still higher longevity -- the main reason why any closing of today's 75-year gap will not be adequate in the even longer run.

25%) are not now covered (most at the option of their employing governments). There is no justification for not making the System truly universal.⁹

- *Tax benefits in excess of the payroll taxes retirees put into the System during their working lives (0.31 percentage points).*¹⁰ Taxing only the employer contribution and the imputed returns from both employer and employee contributions would be in keeping with horizontal tax equity, treating equally the income of two taxpayers with the same income.¹¹ Most low-income beneficiaries would be protected by the standard deduction and other defenses in the code for low-income tax payers. Either in part (as now) or broadly (as proposed), taxation of benefits is an indirect form of means-testing -- without, however, the disincentive to save inherent in direct means-testing.
- *Redirect the income taxes on Social Security benefits from the HI to the OASDI trust funds (another 0.31 percentage points).*¹² There is no logic for attributing the associated revenue to the HI trust fund. However technical, the issue of where to lodge this revenue points up the nexus between Medicare's and Social Security's financial problems.¹³ Reduced deficit in the one would simply mean increased deficit in the other.
- *Reflect changes incorporated in the CPI in 1996 by the Bureau of Labor Statistics (also 0.31 percentage points).* Out of concern for

⁹ Covering now uncovered state and local government employees would be troublesome financially for several states, notably Ohio and Massachusetts where those employees are concentrated (Thompson, personal communication 1997).

¹⁰ Taxing benefits reduces them in after-tax terms -- the logic for viewing the taxation of benefits as a cut in benefits rather than as an increase in taxes.

¹¹ Ideally, no worker would pay income tax on his Social Security contribution; income should be taxed when distributed, not when earned. That, however, would be prohibitively expensive for a government that currently generates an estimated \$25 billion per year on the income taxes paid on the Social Security payroll taxes paid by employees.

¹² The revenue would be re-booked starting in 2010, by which time, the assumption is, the refinancing of Medicare will be in effect.

¹³ The income taxes paid on the payroll taxes of employees points up the even broader interlinkage between Social Security and federal finance as a whole. The revenue from that source has always been credited to the general fund, but it could just as well have been credited to OASDI.

the integrity of the computations, all council members opposed making any legislative change in cost of living adjustments.

- *Compute the AIME using 38 years, instead of 35 (0.28 percentage points).*¹⁴ A change of this nature would reduce benefits for future beneficiaries by about 3%. One member of the group opposed it as unfair to women, who typically spend several years out of the work force bringing up their children (1994-1996 Advisory Council on Social Security 1997).

Promising avenues for gap-closing

Such measures are merely illustrative. They were chosen from a wide set of possible actions, all of which carry plusses and minuses, both substantive and political. The broad public policy issue is which of Social Security's potentially conflicting goals -- individual equity (which is reflected in the use of lifetime earnings to set benefits) and social adequacy (which is reflected in progressive benefits) -- should get more emphasis, and which should get less, in a setting of greater potential clash between the two than ever before.

The retirement age, in particular, has to be re-examined in the light of ever increasing longevity. Average life expectancy at age 20 was 67 for men and 70 for women in 1940; is 74 for men and 80 for women today; and is projected to rise another two years by 2020. Even now, the man who reaches age 65 can be expected to live to his 80th birthday; the woman, her 84th birthday -- three and five years longer, respectively, than when Social Security was first established with a normal retirement age of 65.

One approach, advocated by many students of Social Security, would be to lift the normal retirement age (once it hits 67) to 68, and then

¹⁴ Alternatively, payroll taxes would rise 0.15 percentage points for both employer and employee, to provide the same effect on the long-run deficit. Although viewed as preferable to further rise in the retirement age -- which was rejected by all but one of the Maintenance of Benefits group -- the alternative tax proposal conflicts with the group's general rejection of increasing payroll taxes to close the long-term funding gap.

index it to life expectancy. Indexing would maintain the relationship between working and retirement years -- and thereby add a stability feature to the System it now lacks.

Today, retiring in the early 60s, or even at age 65, means spending almost one-third of one's adult life as a retiree, just over two-thirds working. Is that the product of institutional arrangements, like Social Security, that date from the 1930s and that are no longer relevant? And do they make even less sense now because the ratio of retirees to workers is to fall to unprecedentedly low levels?

The ramifications of leaving the retirement age untouched even as longevity increases are far-reaching, extending deep into the world of work itself. Making a living that has to be stretched over ever longer retirement means longer work weeks, less vacation, and more stress -- indeed, a concentration of work effort into 24-hour days that can take an unhealthy toll not only on individuals but on society at large (Steuerle, personal communication 1997). Workers do not accept the lowering of wages and salaries as their productivity reaches a peak, and then declines with age. And employers are reluctant to push for lowering wages when productivity declines, partly because they fear an "age-ist" label in a society that is increasingly litigious, often more over group than over individual rights (Thompson, personal communication 1997). Employers opt instead for forced retirement, even if sweetened by "packages."¹⁵

The point is often made that raising the retirement age hurts manual workers (and others like fire fighters with also physically demanding jobs). It would be imprudent, however, to structure rules for a universal system for a relatively small part of the population. It is the function of the disability, not the retirement, part of Social Security to support the incomes of those unable to work.

One danger (which the 1983 legislation succumbed to) is an increase in the normal retirement age, but no increase in the early retirement age of

¹⁵ Reflecting the trend to forced early retirement, the labor force participation rate of men between the ages of 55 and 64 is now 67%, as compared with 85% in the mid-1960s.

62. Even with an annuity structured to be neutral with respect to age of retirement, many (as is the case now) will opt for early retirement, especially with employers shedding workers in their late 50s and early 60s. As the normal retirement age rises to 67 in coming years, early retirees will pay even higher penalties than now in reduced pensions, which years later will yield even higher poverty rates among the so-called old-old.

Adjustment of the bend points and the percentage factors used to generate PIAs is another area to look for savings. Significant economies could accrue from making relatively small changes in benefits formulas that would affect high-income workers -- by, for example, lowering the 15% factor used to compute the PIA by a few percentage points, or by adding a fourth percentage factor of, say, 10% at top AIME levels.

Lowering the top end, along with added income taxation of benefits, would reduce the redistribution of income from many poor workers to many well-heeled retirees -- a feature of the System that has been widely criticized (Peterson 1996). And it would make the System more progressive in benefits at a time when it cannot possibly subsidize almost all participants as in the past. The degree of progressivity, to be sure, is a matter of political choice. But one thing surely speaks in favor of adding to it: decades of growing inequality in the distribution of wages and salaries, which echo in the retirement savings people are in a position to accumulate independently during their working lives. Increased progressivity would also counter the loss of pension benefits many low-wage workers have incurred as their jobs have been "out-sourced."

The goal of individual equity itself needs to be examined in changing conditions. The 50% spousal benefit may have made sense in the Great Depression. But it has led to the anomaly of relatively high pensions for many couples at already high-income levels as well as to horizontal inequity in taxation. Survivor benefits, in contrast, are often too low to prevent many elderly (especially the old-old) from slipping below the poverty line when a spouse dies. The survivor gets the

higher of (a) his or her own benefit or (b) his or her spouses's benefit. But that means a relatively large loss of income for the survivor whose earnings and whose spouse's earnings were of the same order of magnitude. Because women are now fully represented in the labor force, many more elderly women (who tend to outlive their spouses) will face a large drop in loss when their spouses die. Even now, as many as 30% of women who are over the age of 80 and who live alone fall below the federal poverty line, with the percentage rising sharply as age increases (Moon 1997 in Kingson and Schulz). "Until that problem is addressed, Social Security is less than a success," according to former commissioner Robert M. Ball, one of the System's otherwise strongest apologists (personal communication 1997).

Closing the gap on the tax side

Once almost invisible, Social Security taxes are now higher for most middle-income Americans than are income taxes, at least if the employer contribution is included in the count as income that workers otherwise would receive. The money's worth issue for young workers, who would be disproportionately affected by further rise in payroll taxes, bears repeating. And so does the concern that the System transfers income from many low-income workers to many high-income retirees. Any increase in Social Security taxes, moreover, will crowd out the increase needed to right Medicare's long-term financial imbalance. Medicare can close much of its financing gap on the spending side, although surely not all of it without radical reduction in the scope of the program.

Advocates of closing the 2.19% gap on the tax side argue that the needed increases in revenue are small in the context of a growing economy. Baker (1996 and personal communication 1997), for example, calculates that a series of additions to payroll taxes of 0.1% per year in the 36 years ended 2046 (for a total of 3.6%) would eliminate the long-term deficit. And yet all that would do is reduce the growth of real after-tax wages from, say, 1.0% to 0.9% per year; the level of real after-tax wages would still be half again as high as it is

now. Adding some 3 1/2 percentage points to the OASDI payroll tax (and presumably at least several percentage points more for HI) is almost certain, however, to threaten the financing of the rest of government. The higher the tax rate, moreover, the harder issues of intergenerational equity are to resolve. That the tax rate would have risen slowly over decades will be small comfort to the workers of 2046 -- none of whom would have had a voice in setting the rate.

Several changes in taxation nevertheless are justified:

- Because of the trend to increased inequality in earned income, covered wages have slipped as a percent of total wages, falling from 90% in 1980 to 88% today (Kingson 1996 in National Academy on Aging). And they are headed lower still as the distribution of income at the top apparently continues to widen. A one-time adjustment in the wage base of, say, two percentage points would only return the covered share of earned income to historical norms.
- Including employer-provided health and life insurance benefits in covered wages is also in order. That would promote tax equity between those who pay for health care and life insurance mostly out of pretax income, because those benefits are linked to their jobs, and those who lack such benefits and thus pay for coverage largely out of after-tax income. Including health care benefits in covered earnings, or only including those above the norm, would yield economies in health care that are now blocked by excessively favorable tax treatment of those benefits -- a plus for Medicare even if not for Social Security itself.

Those who would apply traditional remedies (defining those broadly to include equity investment as long as the risks are public and the assets are managed by the government itself) view Social Security as needing mid-course corrections rather than conceptual change. Those corrections, they point up, can be much smaller than in other advanced industrial countries, which face similar demographics. Compared with most other developed countries, the United States has less imbalance in

its age structure, and its payroll taxes are at greatly lower starting levels.

The trade-offs cannot be avoided, however. And, even if there were already a program in place to close the 2.19% gap, the System would not remain in balance simply because of the passage of time, as surplus years get replaced by deficit years, and as longevity continues to rise. As an average for the next 75 years, the 2.19% reflects two extremes: the surpluses of the coming decade and the deficits thereafter; these are projected to reach almost 4% in the 25 years ended 2045 and almost 5% in the subsequent 25 years.

III. Option 2: privatization

Privatization would split Social Security into two parts: a forced savings and investment plan, whose returns would vary with market performance, and a relatively flat payment, tied only to work history, which all beneficiaries would receive.

However attractive the potential returns on equities, it is not investment in the stock market that distinguishes privatization plans. In that respect, those are no different in any fundamental sense from plans to have government invest System reserves in the stock market. The distinguishing feature is individual ownership and control of the assets. All the same, that would not be worth all that much to Social Security participants were it not for the relatively high returns. This explains why advocates of privatization attach such importance to calculations showing how even low- and middle-income workers would have a chance to accumulate wealth under their proposals.

Excess returns to equity and compound interest speak for themselves. Consider, for example, the eventual nestegg of the average earner if during a lifetime of work he or she were to invest in the U.S. stock market the five percentage points of the payroll tax that could be set aside in a Personal Security Account. At historical real rates of real return of 7 1/2% per year, the amount would grow to almost \$700,000

in 1997 dollars over a period of 40 years.¹⁶ Even with a less adventuresome asset allocation -- say, 63% equities and 37% fixed income securities, which would mimic the typical corporate 401(k) plan -- the amount would grow to almost \$400,000, still an enviable nestegg.¹⁷ In either case, the retirement income from the dedicated five percentage points would be a multiple of the small basic payment to be made to Social Security beneficiaries at large.

Only the unlucky and the unadventurous, the theory is, would have to rely on the flat payment for a significant share of retirement income. In doing so, however, they would draw benefits considerably smaller than they would under current arrangements. They are apt to be people with least experience as investors -- typically low-income workers with little or no prior savings, who also have the most to lose since Social Security is apt to be the major source of their retirement income. The flat payment in the Personal Security Accounts plan was as low as \$410 per month in 1996 dollars for those with a full-career work history. While this would rise with average wages, it is only about half the average benefit of new retirees today, among them many with much less than a lifetime of work. A meager payment is unavoidable if as much as five percentage points of the tax rate is to be freed up for individual investment, and if the System is also to be brought into overall balance.

Even if lucky in their investment choices, many retirees would outlive their privatized Social Security assets. At some point in their lives, they too would have to make do with benefits that would be considerably lower than under present arrangements. Consistent with its stress on choice in investments, the Personal Security Accounts plan does not require annuitization -- a boon to heirs, to be sure, but yet another source of risk to retirees who choose not to annuitize. Many presumably would choose not to, and with good reason. Annuitization

¹⁶ The calculation is based on Ibbotson Associates data for the period 1926-1996.

¹⁷ In violation of the principle of diversification of assets (among them human as well as financial capital), roughly half of the equity holdings of the 1,000 largest 401(k) plans are in own-company stock (*Pensions & Investments* 1997). Non-equity holdings are dominated by GICs or guaranteed investment contracts, a close cousin to long-term CDs. Fixed-income assets are projected to return 2 1/2% per year in real terms, in line with the trend from 1926 to 1996 as calculated by Ibbotson Associates.

is costly through private markets because of adverse selection; it is attractive to people who believe (often with inside information) that they will live longer than actuarial tables project, and thereby it is costly to everyone else.¹⁸

Other personal financial planning would be affected by doing away with the essential feature of today's Social Security: defined benefits automatically annuitized at retirement age. Able to count on such benefits, households can assume greater risk with their personal savings, in order to build capital for retirement income beyond the rock-safe base Social Security provides. If risk were introduced into the Social Security part of a retirement portfolio, the risk-return calculations on the rest of that portfolio perforce would also change. At least in part, the returns from privatization that even lucky investors would reap would be offset by lower returns from more risk-averse choices elsewhere in the portfolio.

Advisory and other investment service fees would also reduce the returns on privatized accounts. It would be politically awkward to prevent those who earn little to put their 5% into individually managed accounts -- and, yet, it would be prohibitively expensive to service those accounts (imagine the complexity of servicing the accounts of youngsters who work after school or during the summer). Even for privatized accounts of normal size, administrative costs would greatly exceed those Social Security incurs today. And they would exceed the costs incurred by government if it were to invest Social Security reserves in the stock market. That presumably would be done through index funds whose servicing fees would be no higher than, say, 25 basis points. Scale economies on amounts in the reaches of hundreds of billions of dollars could drive the cost even lower.

It would be hard to keep people from using the assets in their personal accounts for spending as meritorious, if not more so, than retirement. At the very least, it would be heavy-handed for policymakers to prohibit a 55-year-old man from using his "own" account to pay for a

¹⁸ The Gramlich plan departs from the Personal Security Accounts plan in requiring annuitization. It also limits investment risk by constraining asset choices.

grandchild's surgery, but allow him to do whatever he likes with the money when he reaches retirement age. The disabled, unless they had a strong taste for bequests, would be especially hurt by the restriction that Personal Security Accounts not be tapped until retirement age. Those who become disabled would lose much of the income they could count on today, in exchange for the chance to build wealth many of their number would not be in a position to enjoy.

Political as well as financial risks

Privatization advocates acknowledge the volatility of investment in private securities. But they stress that keeping Social Security largely as it is also entails risk -- in the form of political risk of program changes. Indeed, supposedly fixed benefits have turned out to be flexible whenever, as now, the long-run financial soundness of the System cannot be assured.

Timing risks associated with investment are significantly greater than generally acknowledged, however, judging by the long stretches of weakness in the corporate-bond as well as in the stock market in the past. The case for allowing Social Security participants to invest in equities is appealing after 15 years of a virtually uninterrupted bull market. But it would not have gotten much of a hearing in 1978 after a decade of historically low real returns, which averaged a minus 3% per year. And it would have seemed bizarre in the 1940s and the 1950s when, despite the uptrend in the stock market, the memory of the Great Depression and the associated collapse of asset prices was still fresh. Ironically, those would have been ideal times to embark on privatization from the point of view of subsequent returns; now, with stock prices at high levels, perhaps the least ideal of times. The slumping Japanese stock market of the 1990s, after years of speculative excess, provides yet another reminder of the risk of equity investment.

Moreover, political risks -- both to beneficiaries and to the public at large -- are inherent in privatization as well as in amending Social

Security along conventional lines. The flat payment, which would have the stigma of “welfare” to it, would be vulnerable. And pressure to bail out the unlucky (with consequent damage to the long-run health of the System) would be intense, especially if there were a slump in the stock market affecting the planning of large numbers of workers well up in age. Even if years from now, there could well come a time when it would be necessary to reinvent today’s Social Security to “socialize” anew losses that realistically could not be borne privately, and thereby to provide income support to a large minority of the elderly.

Losers, to be sure, would be able to count on the flat payment and, presumably also, on modest returns even from disappointing investment choices. But a privatized system, by design, would not be in a position to supplement those amounts. The key role Social Security has played over the years in reducing poverty among the elderly, especially in the 1960s and 1970s when benefits rose sharply, would be undermined as a result. Privatization would weaken the System’s social-adequacy function, just as that is about to become more important than ever before.

It is not just losers, moreover, who could wind up disappointed. Long-run equity returns of 7 1/2% per year in real terms (which came from growth rates in economic activity and, correspondingly, in profits significantly above those that can be expected now and from uptrend in price-earnings ratios) cannot confidently be extrapolated into the future (Baker 1997). For the 7 1/2% to hold, economic activity would have to advance more rapidly than the expected trend of 2% to 2 1/2% per year; profits would have to mount to implausibly high levels as a share of GDP (and wages thus sink to implausibly low levels); or marketwide price-earnings ratios, which are now near record highs, would have to rise still further.

Financing the transition

Diverting five percentage points from the tax take to privately owned and managed accounts would make it impossible for Social Security to

continue to do what it has always done: transfer income from one generation to the next. Pensions for retirees and for workers to retire, say, in the next ten years would have to be funded from the remainder. And so would the other liabilities of the System, including those to young workers whose contributions, while small thus far, could not be ignored. New monies -- in the form of taxes or in the form of borrowing -- would have to be raised for Social Security to meet all of these accrued obligations.

Ultimately, the transition problem of making good on existing commitments, and of financing privatized accounts at the same time, will disappear. But "ultimately" promises to be a long time under any realistic scenario. Decades of payroll taxes that are higher than they are now, or of budget deficits higher than they otherwise would be, would lie ahead. Young workers would be obliged to finance the pensions of their elders to make good the intergenerational bargain that otherwise would be in default. And they would also have to fund their own Social Security benefits, since there would be no generation behind them to make good on such a bargain. The Personal Security Accounts plan, for example, would add 1.52 percentage points (to be paid by the employee) to the 12.4% tax rate for the next 70 years. And, until about 2030, it also would borrow from the Treasury (and, in turn, from the public since Washington is unlikely to run budgetary surpluses). At the peak, borrowings would reach \$2 trillion (in constant 1996 dollars), which would increase outstanding debt held by the public by roughly half.

The borrowings would be repaid as transition costs retreat after 2030. But for decades they would complicate, if not encumber, federal finance. They would undermine the lending that Social Security, as now structured, will provide to other functions of government in the period ahead of demographic calm. And they would add to the strain Social Security will put on federal finance thereafter when the baby-boom generation actually retires and past lending to the rest of government comes due.

All the while, other government activities -- in a nation seemingly obsessed with deficits -- would be under extraordinary new pressure to cut spending. Identifying activities considered non-essential is hard enough now. Even those who worry the loudest about deficit spending cannot present, let alone get agreement on, an adequately long list. It will be even more difficult to do so with the extra strain privatization would put on federal finance. The danger is not so much the associated rise in the federal deficit, however problematic that would be, but the potential for the emasculation of essential functions of government.

Advocates contend that privatization would add to national saving, on the supposition that households would save more than they do now in response to the high returns to Personal Security Accounts. The Chilean case is often invoked to make the point (accompanying box). Households may well, however, save less, believing that those accounts would supply more of their retirement income goal. How private saving would be affected is not at all certain. But, necessarily, the national saving rate would decline as a result of the enlargement of the federal deficit associated with transition financing.

Government as investor in equities

Investing in private securities, through government, would obviate many of these problems. Most important, that approach would minimize risk by sharing it. There would not be big losers, just as there would not be big winners. And, whatever they turn out to be, the net returns would also be larger per dollar of investment in equities because the investment advisory and other management fees would be significantly lower. Indeed, potential returns on Personal Security Accounts appear attractive not because private management of funds can claim to offer better returns than the market as a whole, but because the plan would have more money to direct to investment in risky securities (Jones 1996).

Having government invest in the stock market is not problem-free, however. It would be hard to make -- even more, keep -- such investment insulated from political control. Tobacco stocks in an index fund, for example, would be at odds with federal efforts to curb smoking and its consequences for public health. Private nonprofit organizations routinely instruct investment managers to use increasingly detailed social screens to square their missions and their financial strategies. The temptation for government to do so would be hard to resist, certainly over the long haul. Government investment in private securities has always been viewed as "socialism through the back door," and rejected more on those grounds than on grounds of risk. That perspective applies now no less than in the past.

Moreover, the increased returns Social Security would capture would be lost to other investors (Greenspan 1996). For the financial markets to clear, investors who would have chosen stocks and corporate bonds over Treasuries would have to be persuaded to buy instead the Treasuries Social Security would forgo. At least in the first instance, returns on Treasuries would have to rise, and those on private securities to fall. Investors as a whole (among them the Social Security trust funds) would be no better off. And they should not be, since such a switch of assets is unlikely to affect the productivity of capital and thus its returns. Returns under privatization would also be vulnerable to such a change in relative returns.

IV. Fashioning a consensus

The Maintenance of Benefits approach, by its very nature, would right Social Security's long-run financial imbalance with minimal dislocation. Privatization would also remedy the problem, but Social Security would be changed, perhaps beyond recognition, in the process -- a steep price to pay for the relatively high returns many, but surely not all, participants probably would reap as a result. Given the opportunity to achieve those same returns by having government itself do the investing, even they are not all that persuasive. Where the investment risk should be lodged, and thus the distribution of those

returns, is the key issue. That is as much an issue of values as it is of economics. With some two-thirds of the elderly deriving 50% or more of their income from Social Security, that risk is of no small concern, however measured.

If, after full national discussion, the choice is to keep Social Security much as it is today, reaching agreement on specifically what benefits to cut and what taxes to raise will not be easy. It will be less hard, however, if the changes ultimately adopted evoked a sense of shared responsibility for restoring the System's long-run financial balance. Workers to retire in the next 10 or 15 years, say, could be expected to buy into a plan that assures their pensions long into the future, even if at the cost of modest reduction in benefits. Low- and moderate-income workers in particular, young as well as old, would likely accept reductions in benefits if those were seen as a way of guaranteeing the kind of base level of support Social Security has traditionally offered the elderly. Organized labor's vocal opposition to privatization points to such acceptance as part of the price to be paid for keeping Social Security a defined-benefits annuity.

Adding to the saving incentives in the tax code -- in effect, moving away from taxation of income and toward taxation of consumption -- would make changes to Social Security taxes and benefits easier to accept. New incentives for saving would graft a variant of privatization onto the System -- one that would give more promise of spurring national saving than simply shifting the assets of Social Security participants from government to private securities. Such an approach, moreover, would have none of the downside of privatization: the risk, the dirigism in the use of what would become one's own money, the redistribution of income to the swift. Savings incentives would have essentially the same effect as the Gramlich plan or any other dedication of a small increase in Social Security taxes to individual accounts, but they would not have the compulsory character.

It would be easier to get assent to increased progressivity in the bend points and percentage factors, for example, if, at the same time, high-income tax payers were to have the opportunity to make larger

contributions to 401(k), IRA, and other tax-deferred savings plans. Such a combination would protect the pensions of low- and moderate-income workers, while offering a reduction in taxes that would move the tax system more towards neutrality as between saving and consumption, which would be a plus in its own right. Young workers at all income levels would find it easier to accept further slippage in the implicit returns on their Social Security taxes if, at the same time, they could more easily build a supplementary retirement nestegg. They would be among those to profit most from tax-deferred income, on the axiom that taxes deferred are taxes never paid.

Broadening the reach still further

Casting the net wide in other ways is also in order. In particular, exacting taxes on labor from employers to finance as much as half of the System is questionable. That builds distortion into the price of labor, and thus into employment (especially of people at the bottom of the earnings scale on whom those taxes are most onerous). Current reliance on payroll taxes to fund much of the rest of the federal government also implies an inappropriately large tax burden on low- and moderate-income households. Replacing the employer's share of the payroll tax with broad-based income taxes would eliminate both of these defects.

The Canadian "double decker" model, in particular, ought to get a sympathetic hearing. General taxation finances a flat payment made to all beneficiaries (which is now means-tested); payroll taxes finance an added payment, which is tied to lifetime earnings. While the particulars that would make sense in the United States may differ, the principle that Social Security's income-support function be financed broadly across the economy, and not by a tax on labor, applies. And so does the principle of financing the individual-equity function through earmarked payroll taxes, although levied only on employees in order to minimize distortion in the price of labor.

Building into Social Security benefit formulas a new measure of flexibility also ought to be considered. While the 2.19% estimate of what is needed to right the System's long-term imbalance is today's best guess, that could be wide of the mark.

One promising way to getting the flexibility would be to link ongoing as well as initial benefits to prevailing wages. Beneficiaries would reap some of the extra income if productivity were to rise more than expected (an outcome, by the way, they would have helped lay the groundwork for during their working lives). If, instead, the economy's performance were disappointing, retirees would share in the shortfall (this, too, on the premise that "all are in the one boat"). Because it would be automatic, adjusting pensions to the actual performance of the economy would avoid the troublesome income distribution issues the nation must now confront. It would redress Social Security's inadequacy as a means of reducing poverty among the old-old. It would have less measurement problem than linking benefits to inflation. And it would promote the sense of shared responsibility that is needed for a consensus to emerge on how to adapt Social Security to new circumstances.

Such an approach would, it is true, raise System costs because real wages rise with productivity. But other changes to benefits formulas could be made to offset such rise. Benefits could be lowered earlier in retirement, when other sources of retirement income can readily be called on in most cases. Replacement rates are hardly immutable, judging by the System's history.

Even if existing benefits remain linked to the price level, the pattern of benefits should be shifted forward. If Social Security can be made a fair annuity for someone retiring at any age between 62 and 70, it can be made no less fair by skewing the distribution of the same lifetime benefit to the later years. In any case, the high poverty rate of the old-old cautions against arbitrary reduction in cost-of-living escalation based on broad-brush estimates of how much inflation is overstated.

Broader challenge

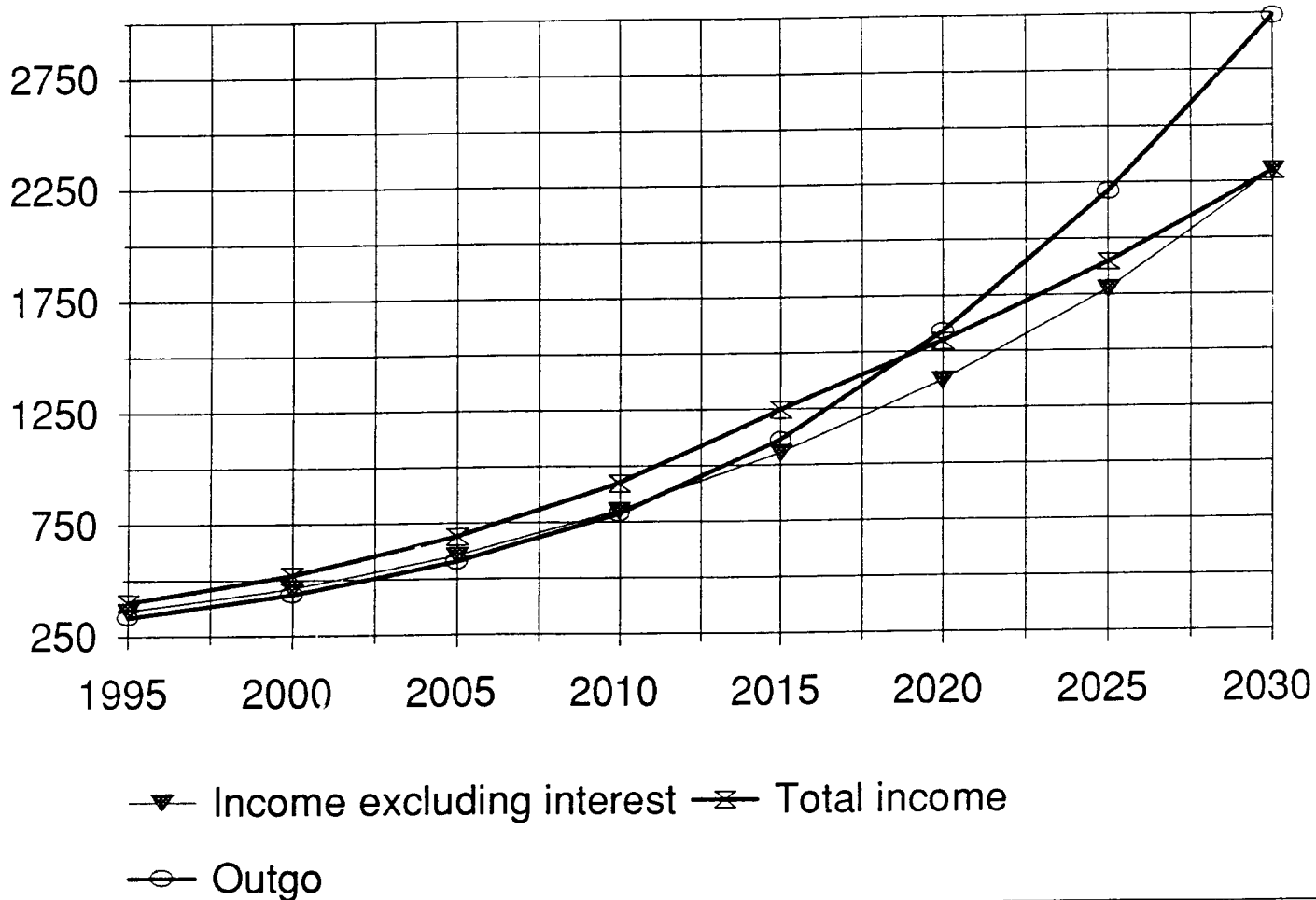
It is important in the debate on Social Security's future that the nation not lose sight of the broader problem the coming demographics present: an uncommonly large transfer of *real* resources from the working to the retired population. This is in the offing, however the baby-boom's Social Security benefits are financed, however much the baby boom itself saves independently for its retirement, and however much the economy grows in the meantime.

This broader perspective counsels not more saving per se, but investment -- presumably most of it public because of the time horizon -- that will yield dividends long into the future, and that will thus ease the transfer of resources across generations of markedly different size. It also counsels encouraging people reaching retirement age to stay in the work force, and to be actively engaged in community service (Levy 1995). There is little to be gained, and much to be lost, by having low ceilings on earnings touch off loss of benefits. The nation can ill afford incentives to shelve human capital prematurely, even if its productivity has slipped from peak levels.

Finally, greater priority should be put on reducing the nation's current account deficit. The transfer of income to foreigners that ever growing external indebtedness points to cannot but make the transfer of Social Security income across generations of markedly different size all the more difficult to effect.

OASDI income and outgo

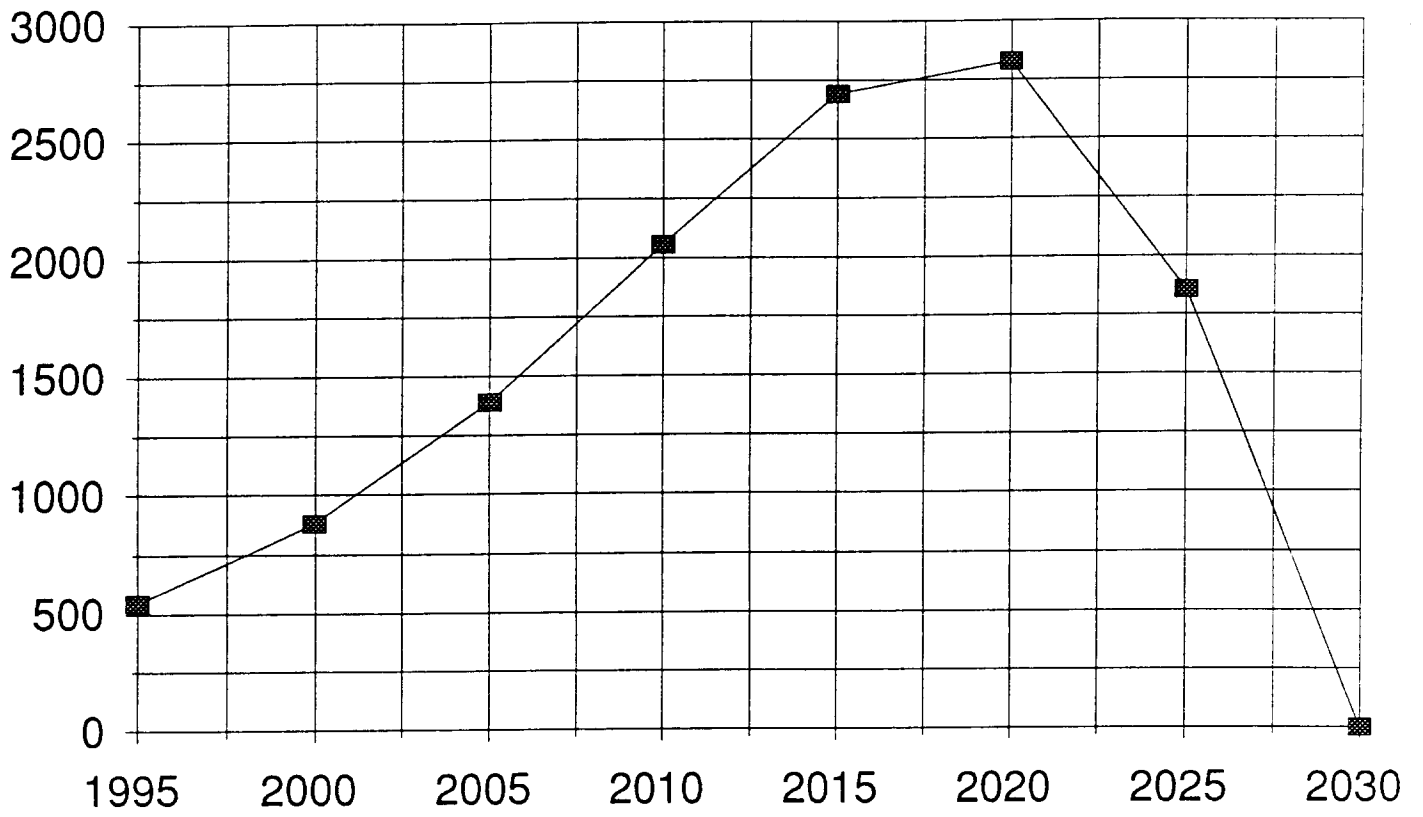
[Billions of dollars]



Source: 1996 OASDI Trustees Report Table III B3

OASDI assets

[Billions of dollars]



Source: 1996 OASDI Trustees Report Table III B4

Calculating the pension of the average wage earner retiring at age 65 in 1997

(Data for earnings in dollars)

| 5-year period ended | Average annual earnings | Average index factor | Average indexed earnings |
|---------------------|-------------------------|----------------------|--------------------------|
| 1996 | 26,500 | 1.00 | 26,500 |
| 1991 | 21,800 | 1.14 | 24,855 |
| 1986 | 17,300 | 1.43 | 24,739 |
| 1981 | 13,800 | 1.97 | 27,186 |
| 1976 | 9,200 | 2.82 | 25,944 |
| 1971 | 6,500 | 3.91 | 25,415 |
| 1966 | 5,000 | 5.02 | 25,100 |

Note: The highest 35 years of indexed earnings average \$25,677, which divided by 12 gives an AIME of \$2,140. The calculations are done as five-year averages, only to simplify and shorten the table. The premise is that none of the highest 35 years of earnings came before 1962.

Box

Privatization in Chile: Not a Model for the U.S.

While a success in many ways, the Chilean experience with social security privatization was a response to problems very different from those this country faces. And it was successful in ways that either are unlikely to be replicated in the United States (e.g., bolstering the national saving rate), or are irrelevant (e.g., fostering the development of capital markets).

Chile's social security system was in shambles by the mid 1970s. Payroll tax rates exceeded 25%. Benefits were only tangentially linked to lifetime earnings (which fostered a large underground economy and thus made for punishingly high tax rates for others). Administration was lax, governed all too often by political considerations. Rampant inflation destroyed the real value of reserves. The plan had to be repeatedly infused with general revenue (often plainly printing press money) in order to stay afloat, especially during the early 1970s when the far left governed under President Allende.

Under the military government that deposed Allende, Chile opted for privatization, with broad freedom in asset choice, as a clearly better alternative. The plan is financed only by employees, who got a one-time pay hike of 18% in exchange for leaving employers out of the system. Covered employees' "contributions" (10% of earnings) are made to their accounts at an *Administradora de Fondos de Pensiones*, a new financial intermediary whose counterpart in the United States is, say, the mutual fund. Government maintains a role only as provider of minimum benefits and as regulator of the *Administradoras*. Administrative costs, while very high at the start, have come down to the neighborhood of 2%.

Large surpluses in the general fund (almost 8% of GDP at the peak in 1980) paved the way for smooth transition financing via "recognition bonds," redeemable at retirement and in the meantime lodged in privatized (but still mandatory) accounts. The surpluses, in turn, reflected proceeds from the sale of public enterprises -- part of a broader shift in economic policy away from state socialism and toward private management and direction of the economy after the military took over. The pension deficit (stemming from the recognition bonds) was used to absorb the budgetary surpluses generated by the sale of public enterprises, preempting any move to reduce taxes or to

increase government spending in response to the surpluses. Even at the height of transition financing, the consolidated central government deficit did not exceed 3% of GDP (Santamaria 1991). In this sense, privatization lifted national saving above what it otherwise would have been (The World Bank 1994). Dictatorship made all of this comparatively easy to put into effect.

Returns from the privatized accounts have been impressive. This, however, probably more reflects replacing state socialism with institutions of economic freedom (including developed capital markets) than of privatization itself. Indeed, Chileans, through the *Administradoras*, are still heavily invested (about 50%) in government paper.

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