Joint Economic Committee Republicans
February 2, 1995

A Review of the Findings of the Social Security Advisory Council

Executive Summary

The Presidential Advisory Council on Social Security recently released the findings of its two-year study on the status of the Social Security program. The 13-member panel concluded that the Social Security program is facing serious long-run financing difficulties. The Council emphasized the need to reform the structure of Social Security in order to correct its fiscal imbalance and revive its financial integrity. While all Council members agreed that the present structure of the system should be changed, there were differing opinions as to how this goal should be achieved. As a result, the members expressed interest in three different reform plans.

The Future of Social Security

Under Social Security's existing pay-as-you-go structure, payroll taxes collected from current workers are used to fund benefits for current retirees. Historically, this system has worked well because a large pool of new entrants into the work force has provided ample funding to support a relatively small population of retirees. However, the retiring of the baby-boom generation beginning in approximately 2010 will strain the financial viability of the system.

The Advisory Council projected that the Social Security trust fund will turn negative by the year 2012, and will be depleted by 2030, at which point the government will need to adopt alternative funding methods to meet its obligations. It can do this by raising taxes, reducing benefits, or increasing borrowing; but such methods are increasingly being seen as inappropriate solutions.

The Advisory Council's Reform Recommendations

The Advisory Council members unanimously agreed that Social Security is financially unviable in the long-run, and the existing pay-as-you-go structure should be changed. However, they could not agree on a single plan of action. Instead, they were divided among three factions, each favoring a separate proposal.

- The Maintenance of Benefits (MB) plan proposes to essentially maintain the present structure of Social Security. The plan would raise revenue by increasing taxes on Social Security benefits and increasing payroll taxes by 1.6 percent of payroll beginning in 2045. The plan may possibly invest up to 40 percent of the trust fund's assets in equities. A policy board, nominated by the president and confirmed by the Senate, would manage the investments.
- A second plan proposes to create Individual Accounts (IA) funded with a mandatory 1.6 percent payroll tax. The accounts would be held by the government with limited investment choices for individuals. Taxes on Social Security benefits would also be raised under this plan.

- The Personal Security Accounts (PSA) plan would direct five percentage points of the current payroll tax into private accounts. Accounts would be held by the individual and invested according to discretion. The PSA plan would create a two-tiered system consisting of flat benefits and proceeds from the PSAs.

Should the Government Invest in the Stock Market?

The Advisory Council agreed on several different elements which are incorporated in all three proposals. Their inability to support a single reform plan centered around two points of contention: the level of investment and the degree of government control.

Those who favor high levels of investment believe that investing pension funds in the stock market will stimulate economic growth while providing individuals with the opportunity to potentially increase their retirement income. Opponents argue that individuals who are not skilled at investment, or who retire when the stock market is in a slump, will face destitution during their retirement years.

Advocates of government control of the invested funds argue that one centrally-held account would be cheaper to manage and less disruptive to the stock market than millions of individual accounts. Opponents counter that giving control to the government would politicize investment decisions and invite the influence of special interest groups.

A Review of the Findings of the Social Security Advisory Council

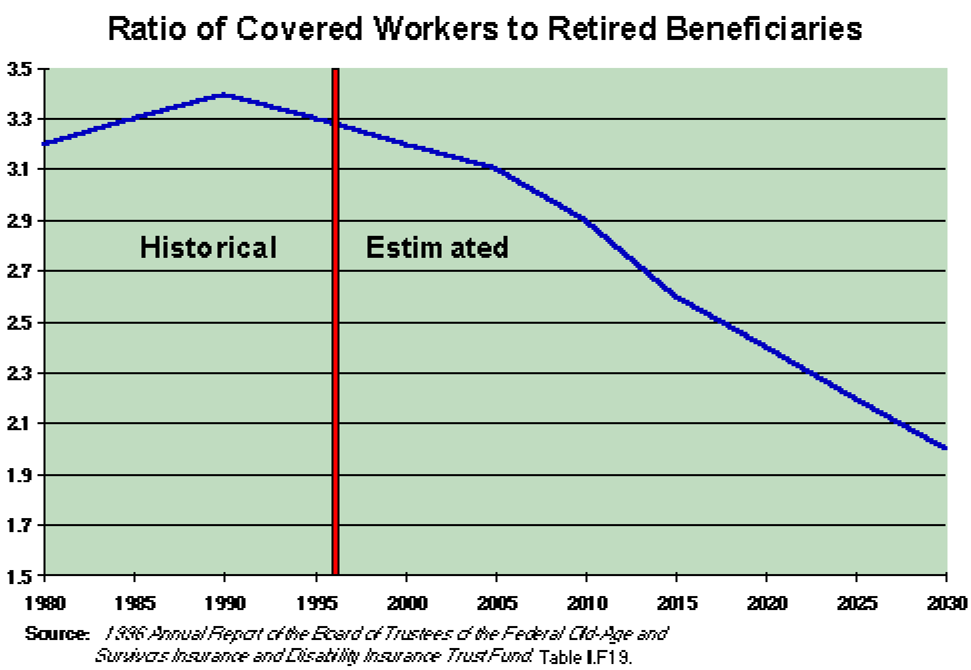
Introduction

The Social Security Act requires the appointment of an advisory council every four years to review the status of the Social Security and Medicare Trust Funds in relation to their long-term commitments. In accordance with the act's provisions, the 1994 - 1996 Advisory Council on Social Security was appointed by Donna Shalala, President Clinton's Secretary of Health and Human Services, to evaluate the long-term viability of the Social Security program. In a report which details the findings of its two-year investigation, the 13-member panel stated that "there are serious problems in the long run" regarding the financing of Social Security.[1] The Advisory Council emphasized the need to reform the structure of Social Security in order to correct its fiscal imbalance and revive its financial integrity. While all Council members agreed that the present structure of the system should be changed, there were differing opinions as to how this goal should be achieved. As a result, the members expressed interest in three different reform plans. This paper provides an outline of the Advisory Council's recommendations, but does not endorse any particular proposal.

The Future of Social Security

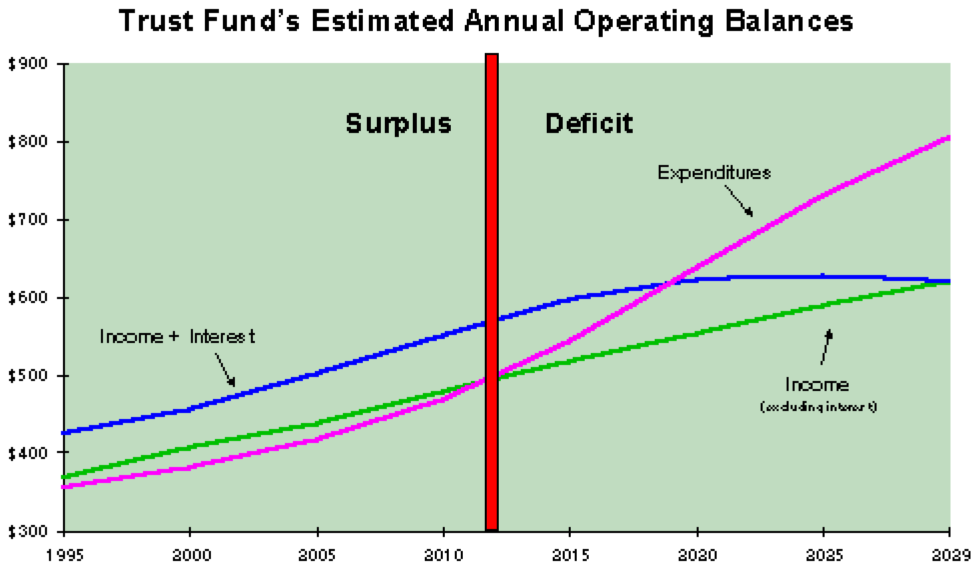
The problems facing Social Security primarily stem from the aging of the U.S. population. Under Social Security's existing pay-as-you-go structure, payroll taxes collected from current workers are used to fund benefits for current retirees. Historically, this system has worked well because a large pool of new entrants into the work force has provided ample funding to support a relatively small population of retirees. However, the retiring of the baby-boom generation beginning in approximately 2010 will strain the financial viability of the system.

Figure 1 shows that the number of workers supporting each retired American is declining. In 1950, there were approximately 16 working Americans for every beneficiary; today there are approximately 3 workers funding each retiree; and by 2030 the ratio is expected to worsen to 2 to 1. The decrease in the ratio of working Americans to retirees will place a tremendous burden on workers who are already paying high payroll taxes.



A 1983 amendment to the Social Security program modified the system to cope with this anticipated burden. According to its provisions, baby-boomers would pre-fund their own retirement by paying higher payroll taxes during their working years. Revenue would be placed in a trust fund to be drawn down upon their retirement. It was estimated that the trust fund would remain solvent until 2063. However, Americans are retiring earlier and living longer, thus collecting more benefits in an economy that has been growing slower than expected. Social Security's trustees now project the trust fund's assets will be depleted sooner than expected.

Figure 2 provides a graphical illustration of the fund's annual balances. According to the trustees, "tax income is expected to exceed expenditures until 2012...From that point on the tax rates scheduled in present law are expected to be insufficient to cover program expenditures...If no corrective action were taken, trust fund assets would be exhausted by the end of 2029".[2]



Source: *1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.* Table II.B2

The dynamics of the trust fund make it necessary for the government to take action before the fund is completely depleted. This is because the portion of trust fund revenues which is not paid out in the form of current benefits is used to finance government operating expenses through the purchase of Treasury bonds. Thus, the trust fund is full of IOUs rather than accumulated savings. When the operating balance turns negative in 2012, the government will need to adopt alternative funding methods. Earned interest on the fund's assets will be sufficient to cover the shortfall until about 2018, after which point the government will have to redeem its IOUs to meet its obligations. It can do this by raising taxes, reducing benefits, or increasing borrowing; but such methods are increasingly being seen as inappropriate solutions.

In addition to the financing problems, the Advisory Council cited several other reasons for concern. First, they concluded that changes in the demographic makeup of the American population has made the existing pay-as-you-go structure inherently unstable. Whenever the program is brought into a traditional 75-year balance under a stable tax rate, it can be expected that the mere passage of time will put the system into deficit. Second, the Council argued that pay-as-you-go systems are inequitable among generations. Young workers and workers of future generations will pay considerably more into the system than they will receive in benefits. Finally, the Council pointed out that polls indicate that public confidence in the system is exceptionally low.

A Newsweek poll found that 61 percent of adult Americans feel the system won't be there for them when they retire. Seventy-one percent favor letting individuals decide for themselves how some of their Social Security contributions are invested, and half of those polled favor investingrevenues in the stock market.[3]

The Advisory Council's Reform Recommendations

The Advisory Council members unanimously agreed that Social Security's "pay-as-you-go approach should be changed," however, they could not agree on a single plan of action.[4] Instead they were divided among three factions, each favoring a separate proposal. Despite their differences, there was broad agreement on several principles which the Council members felt should guide the reform process. The most important points of consensus are outlined below:

- Action to reform the system should begin immediately so that different proposals can be considered carefully and phased in gradually. This will help workers and employers prepare for the changes, and it will help spread any costs involved in the transition to a different system.
- The new system should involve partial advance funding.
- Cost-of-living adjustments (COLAs) should be maintained.[5]
- The benefit computation period should be extended. Social Security benefits are based on the average of 35 years of an individual's highest earnings. The Council recommended that the computation period be extended to 38 years since the present law will raise the age of eligibility for full benefits from 65 to 67. While this will reduce benefits slightly, it will also induce individuals to extend their working careers and tighten the relationship between contributions and benefits.
- A majority of the Council members favors accelerating the already-scheduled increase in the age of eligibility by 11 years. (This would not be a provision of the MB plan discussed next.)

Three Plans for Reform

Six Council members supported the ***Maintenance of Benefits Plan (MB)*** which proposes to essentially maintain the present structure of Social Security as it is. The plan opposes the adjustment of benefit levels and seeks to reduce the deficit through a series of small steps:

- Taxing Social Security benefits to the extent they exceed the amount paid in by the worker. This is viewed as the fairest way to ask present retirees to share the cost of balancing the system.
- Redirecting a portion of tax revenues from the Hospital Insurance Trust Fund to the Social Security Trust Fund (this plan would be phased in beginning 2010).[6]
- Increasing payroll taxes by 1.6 percent of payroll beginning in 2045.
- Possibly investing up to 40 percent of the trust fund assets in equities. A policy board, nominated by the President and confirmed by the Senate, would manage the investments.

The first three provisions are estimated to postpone the date of the trust fund's depletion from 2030 to 2050.[7] Investment in the private markets, to begin by 2000, is expected to eliminate the remainder of the deficit by increasing the real return on trust fund assets from 2.3 percent to approximately 4.2 percent. Modeling experts contend that investment at this level would increase the degree of financial risk only slightly. If the investment option is not pursued, the MB plan does not propose any recommendations to eliminate the remainder of the deficit, thus necessitating an increase in payroll taxes or a reduction in benefits.

Two Council members supported a proposal to create ***Individual Accounts (IA)*** alongside the Social Security system. This would constitute:

- Taxing Social Security benefits to the extent they exceed the amount paid in by the worker.
- Increasing payroll taxes from 12.4 percent to 14 percent of payroll. This additional contribution would be used to create individual accounts held by the government with limited investment choices for individuals. Upon retirement, the accumulated funds in each account would be converted into an annuity to provide monthly payments throughout the retiree's life.
- Growth of basic benefits would be slowed mainly for middle- and high-wage workers.

Proceeds from the individual accounts are expected to offset the reduction in benefits so that workers in all income groups should expect to receive the same level of benefits as the current system entitles them.[8]

The ***Personal Security Accounts (PSA)*** proposal was supported by five Council members. The plan seeks to replace the pay-as-you-go structure with more complete advance funding. When fully phased in by January 1, 1998, the Social Security program would be transformed into a two-tiered system of flat benefits and individually managed private accounts:

- Workers would direct five percentage points of the current 12.4 percent payroll tax into a PSA. This would equal approximately half of the tax now used to finance retirement benefits. In contrast to the IA plan, funds would be managed and invested at the individual's discretion, and workers would not be required to annuitize their proceeds at retirement. The balance of the payroll tax would fund a modified Social Security program.
- When fully phased in, full-career workers would be entitled to a flat benefit of $410 per month plus the proceeds of their private accounts.
- New rules for the taxation of benefits would be implemented and benefits for several groups would be altered.
- The transition to this system would be financed through increased federal borrowing and an additional tax of 1.52 percent of payroll beginning in 1998 for 72 years.

Current retirees and workers over 55 years of age would continue to receive benefits from Social Security. The two-tier system would be fully effective for workers under 25 who would receive a flat benefit from Social Security and the proceeds from their PSAs. Workers between 25 and 54 would receive a combination of accrued benefits under the old and new systems. This would provide younger workers with the possibility of increasing their retirement income while protecting those who now depend on Social Security. It is estimated that, on average, the majority of workers will receive higher benefits under this plan than the existing program.

The Advisory Council's Comparison of the Three Proposals

The three proposals have several features in common. They maintain survivor's and disability insurance for unforseen changes in income. They keep payroll taxes and contributions within a band of 12.4 percent to 14 percent so that market inefficiencies are essentially constant among different plans. They seek advance funding through some degree of investment in equities.[9] Finally, they try to protect the fairness of retirement income with respect to poverty thresholds.

Impact on Lifetime Equity

One measure of comparison used by the Advisory Council is the equity of lifetime taxes and benefits among different plans. Social Security is becoming less attractive for younger workers and workers of future generations who are paying more into the system than they will receive. The Council members agreed that the new system should correct the generational inequity which prevails under the present unfunded, pay-as-you-go structure.

By this criteria, all three plans are more equitable than the current system for workers of all age groups and income levels (provided that the MB plan invests 40 percent of trust fund assets in equities). The PSA plan provides the best money's worth return for young workers while the MB plan is best for older workers over the next 40 years.

In comparing the relationship between an individual's contributions and benefits, the Council members found that no one plan is superior to the others along all dimensions. The PSA plan generally surpasses the others for full-career workers although the MB plan fares best for disabled workers under 65 and one-earner couples. In general, the rates of return on the IA and MB plans are relatively similar and close to those under the present system.

Impact on the Federal Budget

The Advisory Council also evaluated each plan's impact on the Federal budget. Under the current system, Social Security's surplus will reduce the budget deficit by 0.5 percent of gross domestic product (GDP) in 1998, 0.4 percent of GDP by 2008 and zero by 2014. After 2014, Social Security will increase budget deficits.

The PSA plan would have a negative effect on budget deficits during its 30-year implementation. This would occur because Social Security spending would remain unchanged while revenues would be reduced since a portion of payroll contributions would be diverted from the government trust fund towards PSAs. After 2030, the PSA plan would improve deficits relative to the current system. In addition, the PSA plan would lower government obligations by 31.5 percent because a substantial portion of benefits would be paid from the PSAs.

The IA plan would reduce the deficit immediately by slowing the growth of benefits and increasing taxes on benefits. The 1.6 percent increase in payroll taxes used to create the individual accounts would lie outside the budget. The IA plan would also lower government obligations, but to a lesser extent than the PSA plan.

Under the MB plan, budget deficits would worsen between 2000 and 2014 while investment is being phased in. During this period, government borrowing increases to balance the trust fund and to finance investment. After 2014, the projected returns from equity investment will lower deficits. If the investment option is not pursued, the MB plan would leave unfunded obligations of $406 billion.

Impact on National Wealth

In evaluating the impact on national wealth, the Advisory Council considered several wealth effects. First, the PSA and IA plans entail large accumulations of wealth in Social Security accounts which may trigger individuals to reduce their other retirement savings. Second, the higher level of saving in these plans would contribute to a higher GDP which would allow higher benefits to be paid in the 21st century. Third, the increased Fderal borrowing proposed under the MB and PSA plans might induce *more* fiscal responsibility in the rest of the budget; while the increased holdings of special-issue government bonds in the trust fund under the MB and IA plans might provoke *less* fiscal responsibility. With these wealth-effects in mind, the Advisory Council projects that the PSA plan would generate the most national wealth by 2030, with the IA and MB plans following respectively.

Should the Government Invest in the Stock Market?

The Advisory Council's inability to support a single reform proposal centered around two points of contention: the level of investment and the degree of government control.

Those who favor higher levels of investment in the stock market argue that investment would lead to economic growth by providing the financing necessary to increase the country's capital stock and to fund research and development. Both of these factors would boost productivity, thus leading to increased wages and a higher standard of living.

According to proponents, investment would also benefit American workers by allowing them to earn higher returns on their Social Security contributions. Polls have indicated that a majority of workers, especially young workers, are unhappy with a program that forces them to pay into a system which does not give them the freedom to maximize their wealth. Investment of pension funds would give workers of all income groups the opportunity to take advantage of higher returns in the stock market, thereby potentially increasing their income during retirement.

Critics respond to this argument by stressing the role of Social Security as an "insurance" program. They argue that Social Security is much more than a return on your money. Instead, it is insurance against the risk of poverty in old age, and much like auto insurance, individuals should be willing to pay a premium for this protection.

Opponents also argue that workers who are skilled at investment would pressure the government into allowing them to divert their entire payroll tax contribution into their private accounts. This would leave insufficient funding to finance the rest of the system. Furthermore, workers who invest poorly, or who retire when the stock market is in a slump, may face financial destitution during their retirement.

Finally, there is no guarantee that the stock market will continue to outperform Treasury bonds as it has done historically. Infusing up to $1 trillion into the stock market could drive stock prices up and push returns down. It could also drive up interest rates on bonds, making it more difficult for the government to repay its debt. The only real winner would be Wall Street whose top executives and managers would earn billions of dollar in fees.

Those who advocate government control of the invested funds contend that the government would be able to manage the funds passively, causing less disruption to markets. They also argue that one centrally-held account would be more efficient and cheaper to manage than millions of individual accounts.

Opponents of government controlled investment argue that with $1 trillion at stake, interest groups would push for certain investments that would promise higher returns politically or socially than they would financially. Furthermore, the government could possibly end up owning 5 percent to 10 percent of stocks in all the largest companies. Because the government is a passive shareholder, minority owners could gain majority control in some companies. The government may also own a large share of companies which it regulates, thus posing a conflict of interests.

Conclusions

The Advisory Council concluded that the Social Security program is not sustainable in the long-run and should be reformed to account for the demographic changes the country is facing. Short-term policies which simply raise taxes or cut benefits are making Social Security less attractive without correcting its structural inadequacies. Although the plans proposed by the Advisory Council on Social Security vary in their degree of reform, it is important to note that all the plans recommend some form of investment in private markets to partially pre-fund retirement. The Council recommends that action to reform the system should begin as soon as possible to alleviate the costs associated with implementing a new system.

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Endnotes

1. 1994-1996 Advisory Council on Social Security, *Report of the 1994-1996 Advisory Council on Social Security, Volume 1: Findings and Recommendations* (Washington, D.C., January 1997), page 11.

2. *1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C., June 1996), page 24.

3. Newsweek, January 20, 1997, "Social in Security", pages 21-28.

4. 1994-1996 Advisory Council on Social Security, *Report of the 1994-1996 Advisory Council on Social Security, Volume 1: Findings and Recommendations* (Washington, D.C., January 1997), page 12.

5. Benefits paid out under the Social Security program are indexed to prices and wages. This ensures that the value of the benefits paid to retirees keeps up with the higher prices and rising living standards experienced over time. In its analysis, the Council assumed that there will be a downward inflation adjustment of 0.21 percent per year due to changes in the way the Consumer Price Index is calculated.

6. In 1993, President Clinton increased the portion of Social Security benefits subject to taxation to 85 percent. The revenue collected from the 85 percent taxation is currently credited to the Hospital Insurance program under Medicare rather than to Social Security.

7. The Council uses 2030 as the date of depletion based on the trustees' 1995 annual report.

8. This assumes workers invest the same portion of their IAs in equities as they do now for their 401(k).

9. It is important to note that the MB plan only calls for the *possibility* of private investment. However, since the trust fund will not be balanced without such investment, the Advisory Council's comparisons are made on the assumption that the investment option is pursued.