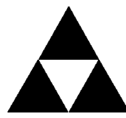

AMERICAN ACADEMY *of* ACTUARIES

Social Security Options

and Their Effects on Different Demographic Groups

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Good morning and thank you for joining us. As Congressman Jim Kolbe said, my name is Ron Gebhardtsbauer and I'm the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the non-partisan professional organization for actuaries in the United States and thus we don't take sides on political issues. Instead we discuss the advantages and disadvantages of proposed legislation. We at the Academy would like to thank Congressman Kolbe and the Public Forum Institute for inviting us to speak and for sponsoring this conference. Social Security has become a very important issue for us all, because we need to put it back in good financial shape. It is also an important everyday issue for actuaries, because we advise Social Security, employers, and individuals with their retirement issues.

Social Security, One Of The Most Successful Programs Ever

I have been asked to provide an overview of Social Security and its financial problems. But first, I would like to quickly second the statements made by other speakers. Social Security has been one of the most successful programs of this country. It is probably the primary reason for the dramatic decreases in poverty rates among the elderly. Poverty rates among Americans over age 65 decreased from 35% in 1959 to about 11% today. This is about the same as poverty rates among people of working ages. However, they are still pretty high for very elderly people, especially very elderly , single women.

Quick Overview of Social Security

Social Security is a very complex program with many benefits, so I'll just hit the highlights. My next chart shows the **size of retirement benefits** you can expect to get from Social Security based on your average annual indexed earnings at retirement. For example, if your average earnings are $20,000 per year, you will have almost half (actually about 47%) of your earnings replaced by Social Security (or almost $10,000 per year). If your average

earnings are $60,000 per year, you will have only 1/4 (actually about 27%) of your earnings replaced (or about $16,000). Thus, you can see two of Social Security's primary goals from this chart. Namely, the tilt in the graph points out Social Security's concern for socially adequate benefits. Social Security provides a safety net for those that have nothing else. (However, people really need to save more in order to maintain their standard of living.) In addition, the following graph shows that the more one pays in, the more one gets from Social Security. This demonstrates Social Security's other goal of individual equity. Without this second goal, people might try to avoid paying more in taxes if they knew they were getting nothing for them.

These benefits are payable at the Social Security Normal Retirement Age, which is age for full benefits and is currently age 65. However, starting just next year (the year 2000), this age gradually starts to increase for people born in 1938 and later. I have a chart in my handout which can help you determine your retirement age, and you can take it with you for future reference. Currently, the **Normal Retirement Age goes up to age 67** and that applies to people born in 1960 and later. Thus, the Generation X'ers in the room will need to wait an extra 2 years (until age 67) to get the benefits on this chart. I should probably also note that the average Generation X'ers will probably live more than 2 years longer than the average elderly person of today, so they should receive more in total lifetime benefits than current retirees.

Social Security also has **early retirement benefits**. You can receive a benefit as early as age 62, but your benefit will be reduced by 20% (currently) to reflect the fact that you will receive it for 3 more years. In addition, you can delay your retirement date and thereby get a larger benefit. Pretty soon, the rules will automatically increase your benefit by 8% for every year that you delay your retirement (up to age 70). That's called the **delayed retirement credit**.

In addition, your retirement benefits from Social Security are **guaranteed**, in that they don't depend on how well you invested your money, they increase every year by **inflation** and are **payable for as long as you live**. Currently, you can't buy inflation-indexed annuities from insurance companies and only a few private-sector pension plans in the country have it. This is a very special benefit you have from Social Security. Because of it, you don't need to worry

about inflation's impact on your benefit or outliving your benefit, no matter how long you live, and you don't have to worry about how to invest your money.

The heading on this chart also points out another benefit of Social Security - **the disability benefit.** If disabled, you can get these same benefit amounts - the same as a retiree, even if you become disabled at a young age. It is an insurance benefit. The value of the disability benefit for an average young person with a wife or kids could be almost $200,000 which is much more than they would have paid in.

Another insurance benefit is the **survivor benefit** (see chart in handouts). Your surviving spouse can get a benefit if she (or he) is caring for your child (or is disabled and over age 50). Both your surviving spouse and the child can get a benefit equal to 75% of your benefit. It could be worth $400,000 for a person who died leaving a wife and 2 young children, and would be worth much more than paid in. After your surviving spouse reaches age 65, her (his) benefit can start up again at 100% of your benefit, even if she (or he) never paid into Social Security.

The chart also shows that your spouse can get a **spousal retirement benefit** in addition to yours when you are both alive. Even if the your spouse never worked, she (he) would be eligible for a benefit equal to 50% of yours. The survivor and spousal benefits are also payable to **divorced spouses** if the marriage lasted at least 10 years (and the spouse hasn't remarried - generally). This is valuable, especially for the traditional family where only one spouse works. Social Security has several other benefits, but I need to move on to my next topic: Does Social Security have a financial problem?

Social Security Has a Financial Problem

I also have to agree with earlier speakers that Social Security does have a financial problem. The actuaries at the Social Security Administration project that if no action is taken, Social Security will run out of money around the year 2034 (using the intermediate set of assumptions). However, that doesn't mean that Social Security won't be able to pay benefits at that time. According to the intermediate projections, when 2034 arrives, payroll taxes will still be enough to pay 71% of the benefits. Another set of assumptions is more optimistic (the funds don't run

out) and another set is more pessimistic (funds run out in 2024), but most people agree that the intermediate assumptions are the ones to base our decisions on.

Social Security's financial problems are due to the very large baby boomer generation and our longer life spans[1]. When Social Security was first created, it was called "Old Age Insurance". Life expectancies were less than age 65 and retirement was a contingency. Today life expectancies are over age 75, and everyone talks about "when" they retire, not "if". In fact, someone who is already age 65 can expect to live into his or her 80's. Due to these longer life spans and the retirement of the baby boomer generation, there will be fewer workers supporting more retirees in the future (unless we make some changes). For instance, today there are almost 3½ workers per beneficiary. By 2034, the 3½ decreases to just 2 workers per beneficiary. But 2034 is many years away. Why are we so concerned now?

It's because, in 2008, the very large boomer generation can start getting Social Security retirement benefits (1946 + age 62 = 2008) and that can start causing major problems with the US Budget. In order to avoid deficits, we may need to have our changes in effect by 2008. (The problems are due to the interaction of Social Security with the US budget. Currently, Social Security receives about $70 billion more in taxes than it pays out in benefits and administrative expenses, which helps the U.S. budget appear about $70 billion better than it actually is. (If one also counts the interest that the Treasury pays on Social Security's government securities, this number is over $120 billion.) Starting around the year 2008, when the baby boomers start to retire, the $70 billion in extra taxes from Social Security will start going down, and will reach zero around the year 2014[2]. This could cause deficits, which means we would have to either increase taxes or decrease government programs at that point. But we shouldn't wait until then to decide on the changes. We need to fix Social Security sooner rather than later. For example, if we fix Social Security next year:

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[1] However, we knew about these problems in 1983 when we last fixed Social Security. Why has it gone out of balance again? The system started going out of balance in the past 10 years because of changing assumptions about the future in other areas, such as future economic growth. Other reasons are: increased numbers of disabled people, changed calculation methods, and the inclusion of the 76th year in the next 75-year projection, which always has more benefit payments than tax income.

[2] This means that the Social Security system will have to cash in some of its Treasury bonds in 2014. Unless the Treasury has surpluses then from Federal Income Taxes (which is possible if CBO's projections of surpluses until 2025 hold), the federal government will face some tough choices. It can increase taxes or cut spending on programs like education and defense. Alternatively, it can issue more bonds, which will increase the deficit (which eventually must increase taxes). Thus, in order to avoid causing deficits in the U.S. budget, some solutions need to be in effect by then. Any solutions effective before then, actually mean Social Security is providing more surplus to the US Treasury for borrowing, unless it is invested in the private sector. If the additional amounts are invested in the private sector, discussions of advance funding Social Security could occur without the complicating effects on the US deficit. However, there would be effects on the US stock (and bond) markets.

(1)the fix does not have to be so drastic (since more people can be a part of the solution),

(2)we can phase-in the changes gradually (in order to avoid larger notches[3]),

(3)we can plan ahead for the changes, and

(4)we can restore people's faith in the system and in government.

Solving the Problem

So let's talk about some solutions. We can either decrease Social Security benefits or increase taxes (or investment income). On this slide, you will see various options for reform, and how much of the problem they solve. For example, the second option is reducing the annual Cost of Living Adjustment (or COLA) that retirees get. If you reduce the COLA by ½ percent each year, it would solve about 1/3 of Social Security's financial problems. Actually, you'll note that none of the options is a silver bullet that solves all of Social Security's financial problem and all of them have at least one disadvantage. Thus, a complete solution requires 2 or more of the options and everyone could be affected, except possibly current retirees.

In addition, if we only make a one-time fix, the system will go out of balance again in 20 years. We'll be back here in 2020 discussing it again, as long as we continue to live longer. One way to avoid the financial problem in the future is to continue the fixes into the future as we continue to live longer. Examples of fixes that can sustain Social Security for future generations would be

(1)to continually increase the retirement age a little every year as we live longer, or

(2)gradually increase taxes a little as we continue to live longer.

So, let's start discussing the details of each of these options. I will first discuss the current rules and then the proposed change. Then I will give it's advantages and disadvantages and discuss who, in particular, is affected by the change.

Decreasing Benefits

[3] Notches were noticeable decreases in benefits like the one that occurred in the early 1980s to certain birth-year cohorts due to the 1977 Social Security amendments.

The first 5 options decrease (or delay) benefits. The first option addresses head on the fact that we are living longer - it would **Raise the Retirement Age for full benefits**. Currently, Social Security's Normal Retirement Age, or age for full benefits, is age 65. But the Normal Retirement Age starts increasing very soon. Starting in the year 2000, just ½ year from now, the age for full benefits starts increasing for people born in 1938 and later. It quickly levels off at age 66 for 12 years. So for people like me, our normal retirement age is age 66, and that's true for the first half of the baby boomers. The retirement age for full benefits then starts going up again, and finally reaches age 67 for people born in 1960 and later. Thus, those of you here who are Generation X'ers will have to wait until age 67 to get full benefits from Social Security - that is, you'll have to wait 2 years longer than current retirees did to get full benefits. Of course, since you are expected on average to live more than 2 years longer, you will get at least as many years of benefits as current retirees did (on average).

One option is to increase the retirement age to 70 by the year 2030. Thereafter, this option would continue to increase the retirement age for full benefits (but at a slower rate), in order to keep the system from going out of balance in the future. Who here was born after 1943? Genereration X'ers will have to wait at least 3 years longer to get a benefit compared with the current rules, although they will still get benefits for more years than people who retired in the early years of Social Security. This affects a lot of people, which is why this option solves over ½ of Social Security's current financial problems. It also would affect all baby boomers like me who would then have to wait until age 67 or later for full benefits. **Supporters** of this option note that it makes sense since we are living longer, and we are healthier at older ages now. As I mentioned already, it can help solve about ½ of Social Security's financial problem. (In fact, if we raised the retirement age to 73, it would solve all of the problem - but I bet that Congress won't do that.) **Opponents** of raising the normal retirement age note that it could be difficult for people who have physically demanding jobs and others who can't find work, or for those who are partially disabled (but not disabled enough to get disability benefits). It could also increase the average age of the workforce and raise employer costs for wages and benefits, such as health care. Employers could encourage us to retire by improving our pensions, but that will cost a lot too. Some people question whether employers will hire us at older ages. They wonder if our health is improving as fast as our life span. Supporters cite recent studies, however, that indicate that we are healthier now at age 70 then people were at age 65 when Social Security was enacted. In addition, before Social Security most people worked to age 70 and beyond.

Opponents also note that low-income minorities with shorter life spans will be affected more by this provision. Supporters note, however, that they are helped by the progressive benefit formula of Social Security, so they will still receive a better money's worth on average, than other groups.

By the way, you can still retire at age 62 under the current rules, and if you do, your benefit will be smaller to reflect the fact that you will get your benefit for more years. For example, if and when the retirement age for full benefits becomes 70, then the benefit at age 62 would be 55% of your benefit at age 70. Thus, an increase in the retirement age for full benefits *is* a decrease in benefits (except for disability retirees - they would not be affected by an increase in the retirement age) and it does reduce the money's worth of our contributions, which is true for most solutions to fix Social Security.

The second option is to **Reduce the Cost of Living Adjustments** (or COLA's) that retirees get each year. Currently, benefits go up by the annual Consumer Price Index (or CPI) so that retirees can buy the same quantity of goods and services each year. However, some people think that the CPI overstates inflation rates. A Congressional Commission (informally called the Boskin Commission), reported that the CPI was too high by 1.1%. One suggested option might be to reduce the COLA to **CPI minus ½ percent**. If the Commission was correct, peoples' purchasing power would not go down and this could solve about **1/3** of Social Security's financial problems. Pretty powerful just for a ½ % reduction. However, the Bureau of Labor Statistics has recently improved their calculation of the CPI. They expect it to lower the CPI by about 3/4 of a percent. Thus, **opponents** of this option are concerned that reducing the CPI further by 1/2%, could mean that retirees would fall behind in purchasing power by ½ % each year. This may not seem like much, but it's cumulative, so that after 30 years of this slippage, a retiree's purchasing power could have fallen behind by about 15% (½ % times 30 years). Thus, it particularly hits the very elderly, where poverty rates are much higher (especially for women). In addition, opponents want the calculation of the CPI to be a technical calculation, not a political decision.

The third option is to **reduce benefits by 5%**. It would be phased in over 5 years, so current retirees (and those currently eligible to retire[4]) would not be affected. People at all income levels would have their benefits reduced by 5%. This option solves about **23%** of Social Security's financial problems. **Opponents** note that this is especially difficult on people with low incomes, since they often rely on Social Security for all (or almost all) of their retirement income. This would also increase SSI and Medicaid costs. Opponents would encourage us to look elsewhere for solutions, such as making the benefit formula more progressive (i.e., lowering the benefit formula for higher wage earners only, or by instituting a means test in retirement, which is the next option) . **Supporters** think everyone should be a part of the solution, even people with low incomes. In response to the concern for low income people, they think that the progressive tilt in the benefit formula is right where it should be and that making it more progressive would make the money's worth of Social Security even worse for high earners.

The fourth option would be to gradually reduce benefits for those retired people whose total retirement income (including Medicare, which is about $6000 per spouse) exceeds, for example, $45,000 per year. It is sometimes called an **affluence test or means test**. Once your family's total retirement income reached $110,000 in any year, you would get only 15% of your Social Security benefit (i.e., just a return of your contributions). When I discussed this option with my parents, they thought it could be a good idea. They figured it would only affect the millionaires, not them. When I told them they would be affected (since their total family retirement income including Medicare was over $45,000), they weren't so positive about it anymore. Their total family retirement income isn't much over $45,000, so they would only lose about 1/3 of their Social Security benefit. Thus, how you think about this option, may depend on where you stand. This option solves **3/4** of Social Security's financial problem[5]. **Supporters** note this option preserves benefits to those most in need and reduces them for those who don't need them as much. **Opponents** note that the option hurts people who saved more, a behavior we want to

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[4] Benefit cuts generally do not affect people who are eligible to retire, because otherwise, it would push many of them to stampede into retirement before the law went into affect (in order to avoid the benefit cut).

[5] It's a large number because the Concord Coalition Means Test affects so many people so much. Many years in the future it even affects people at the minimum wage, because the $40,000 threshold only increases with the CPI. If it only affected millionaires, it wouldn't help anywhere near as much.

encourage, not discourage. It could also discourage pensions. This option might also encourage abuse. People might hide their income, put their assets in trusts or give it to their kids, so that their Social Security benefit is not cut. In response, the government would write regulations to stop the abuse, which could become quite complex and intrusive. Opponents other concern is that an Affluence Test could change the very nature of the Social Security program away from being a universal program where benefits are based on how much you contribute to one based on need. Opponents would rather use the progressive tax system to handle this (which I will discuss later) or make the benefit formula more progressive.

Another option would be to **increase the number of years for calculating your benefit from 35 to 40.** Currently, benefits are based on your highest 35 years of earnings. Additional years of work beyond 35 years do not improve your benefit much. One option would raise the 35 to 40, which would *solve 21% of the problem*. If you worked full-time for at least 40 years, this option would not change your benefit much at all. However, if you didn't work full-time for 40 years, your benefit could go down by as much as 12%. **Opponents** note that this would have the unintended consequence of hurting women who take time out to care for their families. **Supporters** note it would encourage people to work longer in order to get a better benefit. This would be good for the country because it would create more productivity, and it would help bring in more contributions for Social Security. (This option makes the charge for early retirement more accurate. The current method doesn't reflect the fact that early retirees contribute less to Social Security.) Furthermore, supporters don't want to hurt women who stay at home for child birth and child care reasons. They could remedy this problem by providing women with drop out years for periods when they are carrying or caring for a child.

Solving the Problem - Increasing Taxes

The next 4 options solve Social Security's problems through raising taxes. For example, option 5 suggests we **raise the payroll tax rate**. Right now, you pay 6.2% of your wages into Social Security and your employer does too. Self employed individuals pay both parts, for a total of 12.4% of earnings. This option would increase the

total tax rate by 1% of wages (half to employees and half to employers), so that employees and employers would each pay 6.7%, for a total of 13.4% of wages. **Supporters** note that this solves almost **half** of Social Security's current financial problems and that people prefer a tax increase over a benefit decrease. Raising the total payroll tax rate by 2% to 14.6% would solve the current financial problems of Social Security if it was really saved[6] . **Opponents** ask where the money will come from? Employers will have to raise prices if they can or lower their costs, such as labor costs. Low income people may take it out of their 401(k) contributions and lose their employer's matching contribution. Others might have to borrow more or consume less. Opponents also note that we may have to increase payroll taxes for Medicare too, so that total payroll taxes could get much higher in total. In addition, as we continue to live longer, we will have to increase taxes every 20 or 25 years (unless we really save the money or unless FIT are large enough to redeem SSA's bonds). This would tax future generations more than we were willing to tax ourselves today. It will be too late then for our children to cut our benefits or increase our retirement ages, so they could be forced into paying higher taxes than what we ever paid. Since this option is particularly difficult on lower income people, many would prefer that only higher income people pay more taxes, which is the next option.

The sixth option would **raise the amount of wages that are subject to the payroll tax**. This year, people pay Social Security taxes on the first $72,600 of their wages. That's known as the maximum taxable wage base and it goes up every year by the percent that average wages go up. This option would increase the amount of wages subject to payroll taxes over the next 5 years to $105,000 (which is about $90,000 in today's dollars). This particular option solves **1/4 of Social Security's financial problem**. Eliminating the cap and paying taxes on all pay would solve about ½ of the problem. **Supporters** note that low-income people pay Social Security taxes on all their income while high income people don't, and they can afford a tax increase better than low income people. **Opponents** note however, that Social Security benefits for high income people don't go up much for each additional dollar that they put in, because of the progressive benefit formula. (Eventually, this change would

[6] This assumes that the additional funds are saved (e.g.,invested in equities or used to lower the national debt; not other purposes, such as a decrease in Federal Income Taxes).

produce some unnecessarily large benefits for people that may not need them, unless the rules were changed to disregard the higher wages in the benefit calculation. However, if that happened, then some of the individual equity goals of Social Security would be hurt. Currently the more you put in, the more you get out of Social Security.) If people at higher incomes didn't get much or anything more for their additional contributions, then they might find ways around paying the additional taxes, and they would be less likely to support the system.[7] In addition, opponents note that this increases the taxes on businesses, which means they have to either raise their prices if the can, or cut costs, such as labor costs.

The seventh option is to **tax Social Security benefits like pension benefits from a private pension plan**. Currently, a retired couple with a $20,000 pension and nothing else, would be taxed around $500 or so. But if the income was all from Social Security, there would be no tax on it. This is because you are not taxed on your Social Security benefits if your total income (including ½ of Social Security) is below $32,000 (or $25,000 if you are single). Above those thresholds, you are taxed on only half of your Social Security benefit. However, if this income is above $44,000 ($34,000 if you are single), then up to 85% of your Social Security benefit is taxable; not the whole benefit since your contributions were taxed already. (They chose 85% because approximately 15% of your benefit comes from your own contributions which have already been taxed; the rest of your Social Security benefit is attributed to investment earnings and your employer's contributions, which have not been taxed yet.) As you can see, this is quite complicated. This option would eliminate the thresholds, which would simplify the calculation a lot. **Opponents** are concerned that this might hurt low and middle income people. However, **Supporters** note that low income people will not be touched by this proposal. In fact, 30% of retirees would still pay no income tax due to the exemptions and deductions in the Federal Income Tax system. Only middle income people are affected. Their annual taxes could increase by up to $3000 (see charts)[8], which is why

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[7] Studies at the World Bank show that when people get little or no benefit from additional taxes, they are more likely to under-report their income. Italy's system has this problem. In fact, we do too (e.g., wives in low paying jobs).

[8] The most someone could be affected would be that 85% of their Social Security benefit would become taxable at a 15% tax rate = 12.75% of their benefit or about 5% of their total income. People above the first threshold would have 35% of their benefit become taxable at a 15% rate = 5.25% of their benefit or about 1% or 2% of their total income. See charts.

Moynihan's proposal phases this change in. This option doesn't help solve much of Social Security's financial problems (only **14% of the problem**). Supporters also see this option as a way for all generations to be a part of the solution, even current retirees, and they note that it simplifies tax laws. They question why two retirees with the same income are taxed differently, just because one person gets their benefit from Social Security and the other doesn't. Opponents are still concerned about the increase in taxes, and note that Roth IRA's are taxed less.

The eighth option **requires all newly hired State and Local Government workers to be in Social Security**. Some state and local workers participate only in their own pension systems and don't participate in Social Security. This option would require their new employees to be in Social Security. **Supporters** say that Social Security should be universal, and that most people support this option (except some of those that would be affected). Since many state and local workers get Social Security anyway through work at other jobs, they should have to pay their fair share. **Opponents** note that these workers do fine under their own systems, so why change the rules. In addition, it would divert employee and employer contributions from their government plans. This option would bring more money into the system in the short run, but would solve only **about 10 percent** of Social Security's financial problems.

Unintended Consequences

I've discussed some of the possible solutions. However, there are problems that come along with these solutions. *Decreasing Social Security benefits (or increasing the retirement age for full benefits)* may put more reliance on the private pension system. It will shift costs to employees and employers. People need a certain amount of income to live and retirement is very much a financial decision. So with smaller Social Security benefits (or later retirement), many individuals will have to work longer (if they can). An older workforce will increase employer costs such as wages and employee health, disability, life insurance, annual leave, and sick leave[9]. If employers don't want an older workforce and the associated additional costs, they can lay off their older employees (always a

[9] It could decrease post-retirement health costs, but this would be offset to the extent that Medicare also increases its retirement age. Pension costs could also decrease for employees over the Normal Retirement Age (unless actuarial increases are provided along with accruals) or the age for unreduced benefits.

difficult thing to do) or encourage them to retire by improving the company pension plan, but that will cost a lot too[10]. Due to a huge increase in the number of retirements early in the next century, employers may want to rethink their retirement strategies and encourage employees to stay on (at least part-time). Phased retirement may become popular, but IRS regulations[11] would need to be revised to allow in-service distributions to be payable before a pension plan's Normal Retirement Age. In addition, it is quite difficult for employers to increase their Retirement Ages in tandem with Social Security, unless pension law allows higher normal retirement ages than age 65 and relaxes the rules against decreasing benefits.[12] Otherwise, employers will have to calculate 2 separate pension amounts for service before and after each change in the retirement age. This will be very complex for employees to understand. However, it appears that Congress can increase Social Security retirement ages the easy way, but they won't let employers do it. Congress may want to allow employers some of the same flexibility. Finally, decreased Social Security benefits could necessitate changing the non-discrimination rules to reduce the disparity in benefits between low- and highly-compensated employees..

If *Social Security COLA's are decreased*, it will put more pressure on employer pension plans (at least the Defined Benefit variety) to give greater ad hoc increases to older retirees. It might encourage more lifetime annuity-type benefits and COLAs in pension plans. Employer's with Defined Contribution plans might still be able to wash their hands of this problem, especially if all ties have been lost with the former employee by paying lump sums and not providing post-retirement benefits of any kind. Employees should prefer Defined Benefit plans more, especially if inflation could be high in their retirement, but they may not be thinking that far ahead.

If BLS lowers the CPI, it would also reduce other government retirement benefits (such as the CSRS and FERS benefits for federal employees) and entitlements, and it would increase income taxes (by not increasing the tax

[10] Social Security Offset plans and plans with supplements payable until the Social Security NRA will automatically get more expensive, unless employers amend them.

[11] For example, §1.401-1(b)(1)(i) requires that retirement plans be exclusively for retirement and other incidentals.

[12] See the definition of Normal Retirement Age (65 & 5) in §411(a)(8), the maximum distribution age of 70 ½ for owners in §401(a)(9), the anti-cutback rule in §411(d)(6), and the commencement rules (65 & 10) in §401(a)(14).

brackets as much). In addition, federal limits on pensions would be smaller in the future.[13] It would also affect the economy, by lowering future expectations of inflation, lowering future wage increases, and interest rates.

As mentioned earlier, a *means test* would discourage savings and pension plans. It would also mess up offset plans and the rules that integrate pension benefits with Social Security. The employer pension would affect the Social Security benefit which would in turn affect the pension, and back and forth. As you can see this would create a circular problem, which could wipe out Social Security offset plans and necessitate a change in the §401(*l*) disparity rules. Individuals who were clearly above the means testing threshold would need more income from their employer pension plan or they would need to save more. A means test would also encourage gaming the system. People would accelerate or delay the timing of their employer pension in order to get their full Social Security benefits. If the means test was based on income, people with large pensions would want to receive their benefits in a lump sum, so that they would only lose their Social Security benefit in one year. People with small pensions would not want a lump sum, because their pension would not reduce their Social Security benefit, but a lump sum would hurt them in the year of receipt. If the means test was based on wealth, people with large pensions might want to delay their pension for as long as possible or get it early in a lump sum and hide it or transfer it to a trust or child. IRS would have to create some very complex distribution rules which would make the current IRS distribution rules in §401(a)(9) seem simple.

In the Advisory Council proposal, the *dependent spouse's benefit is reduced* from 50% to 33% of the primary worker's benefit. This would hurt traditional families and non-working wives who were divorced. In addition, the proposal would increase the survivor benefit from 2/3rd's of the couple's benefit to 3/4th's. This would help non-traditional families, but not traditional families (since it doesn't change their survivor's benefit amount). This change may not affect pension plans. On the other hand, it could encourage more employees to follow the example of Social Security and elect Joint and 3/4 Survivor benefits. Alternatively, larger survivor benefits from

[13] See the maximum limits in IRC §415 on pension benefits and contributions and the §401(a)(17) limits on compensation for pension purposes. Some suggest that these limits should increase by wage inflation, not the CPI.

Social Security could encourage employees to feel the survivor is taken care of, so more employees might elect life only benefits (i.e., waive the Joint and Survivor benefit).

If we *increase Social Security taxes*, the money's got to come from somewhere. Low paid *employees* may take it from their 401(k) contributions and lose the match. Highly compensated employees also would be restricted because of the non-discrimination rules. If the employee has no pension plan, the increased contribution would have to come from their savings or their consumption. If *employers* have to pay more into Social Security, they may reduce pension benefits or drop them altogether.

If the *wage base is increased or eliminated*, it will affect covered compensation and integrated plans. If other forms of compensation besides wages are taxed (such as pensions and health benefits or pension trusts), employers might reduce or drop them (and their cafeteria plans), due to the loss of some of the tax advantages. If the health and pension benefit are still not taxed, then it might encourage them. So you can see there are a lot of different repercussions involved in these proposed options. We have to discuss these unintended consequences before we implement changes such as these.

Using Private Sector Investments

So far I've talked about either decreasing your benefits or increasing taxes. Another way to help solve Social Security's financial problems is to invest in the private sector, sometimes called privatization. Either Social Security could do the investing or individuals could. This option is quite controversial on Capitol Hill, because the two parties split ways on which type of privatization they prefer (and possibly because they have not been tried before in the United States). Currently, Social Security's Trust Funds can only be invested in government securities. Investing them in the private sector could yield Social Security a higher investment return. It would reduce our arguments about whether the government really saves the money when it buys Treasuries. And it could increase national savings if *additional* savings were required on top of the current payroll tax (not if it is

carved out of the current tax, unless benefits are cut even more). Sounds like a free lunch! However, it's not, and like all the other solutions discussed above, this change doesn't solve all of Social Security's current financial problems. We will still have to raise some taxes or cut some benefits or a little of both. And these statements are true whether Social Security invests in the stock market or individuals do it. That's because Social Security has historically been a pay-as-you-go system. Most of it's tax income (85% in 1999) is used to pay benefits. The rest of our Social Security contributions create the $70 billion of what some people refer to as the annual Unified Budget surplus. Some people have suggested using this so-called Unified Budget surplus to cut taxes. However, all of that money is actually from Social Security, so if we invest it in the private sector, then there won't be any money for the tax cut.[14]

So, let's discuss these 2 ways to approach **privatization** in more detail. Under the first one, **Social Security** would hire investment managers to gradually invest up to 40% of its Trust Fund assets in the private sector. This option could solve about 40% of Social Security's financial problems. **Opponents** argue that with their assets reaching maybe 5% of the total market, Social Security investment decisions and stock voting could become politicized. They also worry that a large Trust Fund might tempt Congress to improve benefits too easily. **Supporters** note that the government already invests in the stock market (albeit on a smaller scale) without these problems[15] and using stock market indexes could avoid the concern that Social Security would manipulate the market. Proxy voting could be delegated to the money managers. In addition, they note that Social Security could get a higher rate of investment return than if individuals did the investing, the administrative and investment expenses would be less, and there would be less risk on individuals. With respect to the concern that Congress might use the money, supporters note that Congress would be less likely to use the money than now.

[14] If the US Budget is not in surplus, investing in the private sector would create a larger deficit, increase interest rates, borrowing costs, inflation, and eventually taxes (to pay off the deficit). Note: When the baby boom retires and needs to cash in the privately-invested retirement funds, there still will be a drain on society at that time; it will just come from reduced market values and inflated prices on goods.

[15] E.G., the federal employee's Thrift Savings Plan and the Pension Benefit Guaranty Corporation.

Alternatively, to avoid the governance concern, **individuals** could do the investing. **Supporters** prefer advance funding, want the higher return, and want to avoid reducing benefits as much as possible. They suggest that Individual Accounts (even with the risks placed on individuals) are the lessor evil in doing this, because they don't want the government getting involved in investment decisions. Other supporters philosophically prefer individual responsibility over corporate responsibility and they like the idea of wealth accumulation for everyone (we would all become capitalists and want the stock market to do well). The Individual Account proposals would require all individuals to invest their payroll taxes directly in the private sector ourselves. And then we would reap the better returns ourselves. Workers could have their own individual accounts and control all their own investment decisions. It could be on top of Social Security, as a part of Social Security, or instead of Social Security. However, **opponents** note that this could have much larger administrative and investment costs than if just Social Security did the investing.

In addition, there would be very large **transition costs** to change over to a totally privatized system. Back in 1996, when over 90% of Social Security's money was being paid out to current beneficiaries and the US Budget was in deficit, most reform proposals suggested paying for the transition thru **add-ons** (i.e., increased contributions to Social Security). **Supporters** noted that these proposals could have increased national savings, investment, and productivity. **Opponents** asked where this money would come from? Some people worried that employees would take it out of their 401(k) contributions and lose the match. In addition, employers might take it from their pension contributions. Tax lobbyists said add-ons were tax increases, even though the money would go to our own retirement accounts.

Thus, add on proposals fell out of favor and were replaced by **carve out** proposals. These proposals take their mandatory contributions out of what we are already paying into Social Security. This has been made more possible recently due to Social Security's good fortunes. Due to greater total wages bringing in more tax income and lower inflation leading to less benefit outgo than expected, only 85% of tax income is needed to pay the

current benefits to our parents. This leaves 2% of payroll for our own individual accounts. However, if this money is used for Individual Accounts, then less money goes to Social Security and we will have to find more places to cut benefits. For example, if we were to divert 2% of our Social Security taxes to our Individual Accounts, then we would have to come up with more benefit cuts (about twice as much as before) from our prior lists of options. **Supporters** of Individual Accounts point out that those additional benefit cuts could be offset by the increased benefits from the Individual Accounts. **Opponents** note that this may only happen if the stock market does well. In addition they suggest that many people may not do well during the transitional period, because the advantages of investing in the private sector don't build up right away.

The most recent proposals went for the **free lunch** to avoid the above concerns. They have the added advantage in that we now have projections of budget surpluses outside of Social Security. These 2 proposals use some of this surplus, and in addition, they leave some of the financial problems to our kids (through larger deficits). Clinton does this by giving more funds to Social Security after 2010 (when there may be no surpluses). Archer-Shaw gives 2% of pay to Social Security from General Revenues, even though the surpluses are not permanent and Archer would also allow use of the same surpluses for a tax cut. Thus, both proposals avoid the carve out issue because they carve out from general revenues. To Social Security, they look like add ons, but they don't raise our taxes. Thus, the proposals may look better to us, but they have problems. They don't pay down the debt as much as would otherwise happen, and they force more of the financial problems on our kids.

Individual Account Risks: Opponents also worry that Individual Accounts would throw too much risk onto individuals, such as the investment risk, inflation risk, longevity risk (i.e., outliving your money), and leakage risk (i.e., the risk that we would take our money out before retirement). Proponents however, note that they are not

suggesting full privatization, only partial privatization. Opponents are still concerned, because the rate of return arguments can be used until Social Security is fully privatized[16].

Investment risk: For example, if my generation retires when the stock market is down (which could be a likely possibility for the boomer generation), we may not have as much money as we expected and then have to suffer decreased benefits or work longer. The benefit decreases could be much larger than those the notch babies experienced in the 1980's.[17] In addition, some people might invest too conservatively and others might invest too aggressively and fail[18]. Social Security can spread that problem out so that people are affected less. There is also what we call the **longevity risk**. You may take out too much money too fast, or live a lot longer than you expected and not have any more money. There is also **Inflation Risk**.. Inflation could go through the roof after you retire. There are some partial solutions for these risks, but they are not complete. For investment risk, some remedies would be to provide investment education, and to restrict investment options (e.g., only approved indexes, required allocations to stocks and bonds, etc.) , but your expenses would probably still be higher than if one entity did the investing. For longevity and inflation risk, you could be required to buy an inflation-indexed annuity that would pay you for the rest of your life. Of course, that would make Social Security more expensive for **women** (unless unisex annuities were required). There will be other concerns for women too. Unless dependent spouses have some ownership of the Individual Account, they may not get survivor benefits. This is very important, since the poverty rates for elderly women are among the highest.

Another risk is that people might take their money out before they reach retirement (for eminently good reasons such as health, unemployment, or a child's education). This is sometimes called the **leakage risk**. The remedy

[16] Opponents are also concerned because the more money used for privatization, the less that can be used for the socially adequate DB part of Social Security. Supporters would counter that they can tilt the formula further in favor of low paid, but opponents fear that would reduce Social Security's support from higher paid people. It could become more like welfare and eventually be eliminated.

[17] Gary Burtless of Brookings shows how IAs would have fared in the past. Someone retiring in the mid-70's would have replacement rates that were half of what someone who retired in 1969.

[18] The government could provide guarantees against poor investment results, but that could involve the government in the markets again.

for that is to restrict withdrawals (unless you have enough to buy a lifetime annuity equal to the poverty level). However, some people wonder whether Congress can keep these restrictions intact. They haven't been able to do it for IRA's and 401(k)'s. This risk is similar to the one mentioned above that Congress might use the money for other purposes if the fund got too big. The parallel here is that if individuals have the money, they may use it for purposes other than retirement. There is also the risk that people would spend it too fast in retirement. Annuities would also remedy this risk, but would Congress mandate annuities for people who don't expect to live long? One remedy would be to price annuities based on one's health status.

There are also the **death and disability risks**. If you are young, and become disabled, or if you die when young and have survivors, your account will not be enough to provide much of an income. One solution here is to require that people buy disability insurance and life insurance. Alternatively, some proposals only privatize the old age benefit, but don't touch the survivor and disability programs of Social Security. If that happens, then people could actually get the former Social Security disability benefit plus a benefit from the privatized account, which could more than needed. Remedies could be to restrict the Individual Account for old age retirement purposes or to reduce the Social Security disability benefit by the accumulated value of contributions to the individual account (using Treasury rates if you didn't want to penalize good investors).

Administrative Expenses and Feasibility: Social Security is run very efficiently. Their expenses are less than 1% of benefits. If Individual Accounts are mandated, there will be many implementation issues to work out. It might be difficult for the government to enforce every individual to contribute to their Individual Accounts, so employers may be called upon to collect and forward the money. It might also be difficult for employers to direct funds to any fund, so investment options may initially be restricted. Initially, mutual funds may not be efficient in handling small accounts, so the government may provide a clearinghouse for the deposits. The government could be just a default investment fund until individuals get enough funds to invest in the private sector. Employers may have to identify contributions immediately when sent to the government, which will be more work than now. Currently, employers only provide this information on W2s in January of the following year, and 5 ½ million (of

the 6 ½ million employers) file on paper. A huge staff would be needed to handle allocation and annuitization questions, but this could be automated eventually. Currently the federal Thrift Savings Plan has less than 2 million participants. Fidelity (the largest Defined Contribution administrator) manages 16 million accounts, and the whole DC industry manages 44 million. They would have to manage 150 million accounts right away. If employers are used, they would also have to help with the many workers who they can currently exclude from their pension plans today (e.g., the 17 million part-time workers, 9 million young workers under age 21, and the 27 million new workers who may be temporary), and these people would have small accounts.

So there are many different risks under this individual account idea. There are also remedies, such as using a government clearinghouse and requiring inflation-indexed annuities. We need to discuss these remedies to see if they are adequate and whether they are worth using to reduce the risks on the individual. Opponents would suggest that we just stay within the structure of the current system, which avoids all these problems and guarantees everyone their inflation-indexed Social Security pension for life, irregardless of the investment rates in a particular year.

Diversification in the sources of our income is also a very important issue. Papers from the World Bank laud the fact that retirement income in the U.S. comes from more than one source (i.e., the 3-legged retirement stool - four if you count possible earnings)[19]. For example, if the stock market crashes when the baby boom retires, Social Security and traditional DB employer pension plans may be more valuable to employees than Individual Accounts. When the stock market does very well, retirees will benefit greatly from DC plans, personal savings, and individual accounts. When low-income individuals have small savings and pensions, Social Security's subsidized benefit is more helpful. High-income individuals though can't maintain their standard of living on Social Security alone. They need the other legs to do that. If the tax base in the U.S. decreases, retirees can depend more on their advance-funded employer pension plans and personal savings. Thus, there is a very good

[19] Although the World Bank author probably favors a universal, flat, state-managed benefit plus a mandatory Individual Account.

reason to keep all 3 legs of the retirement stool strong. Congress could save the Social Security leg by harming the other legs and end up with a one-legged stool. We must be careful not to hurt any leg and lose this valuable diversification. Some proposals could hurt the employer leg. In addition, we need to be concerned if all 3 legs put too much risk on the individual (i.e., if Social Security moves toward Individual Accounts, employer plans continue to drop traditional DB plans in favor of 401(k) plans, and the individual leg already has 100% of the risk on the individual).

Thus, a **third way to privatize could involve employers** as a part of the solution, and it could solve the governance problem (if the government had the money), the leakage problem (if either government or individuals had the money), and greatly reduce the risk problems (if individuals had the money). An employer with a good retirement plan could have the option to satisfy the individual account mandate for their employees. In fact, it might be easier for 6 million employers with pension plans to meet this challenge, than for 150 million individuals to each set up their own account. Employers that already have a pension plan might not have to do anything. Employers without pension plans would not have to start one (but their employees would have to set up an individual account). **For example, if an employer has an excellent pension or 401(k) plan, then instead of gutting it, maybe it could satisfy the individual account requirement for its employees.** Defined Benefit pension plans could satisfy this requirement[20]. Not much has been developed in this area, and I would be glad to discuss this further.

Let's Start Today

So as you can see, there are many different ways to solve Social Security's current financial problems. In spite of its current difficulties, Social Security has been a great success. The solutions are there. To implement them will take political courage and the determination of the American people. But it can be done, not only for our parents and us, but also for our children. Often when I give these speeches at town hall meetings around the country,

[20] Examples would be Defined Benefit plans with inflation protection, a cash balance minimum benefit, or an always vested employee contribution. Inflation protection could be purchased by employee contributions (and easier to have in pension plans, if Congress would make contributions pre-tax, like in §457 government plans).

retirees ask if their benefits will be cut. The members of Congress invariably and emphatically state that the answer is no. (Maybe their benefits won't go up quite as fast or they will be taxed a little more, but the benefit won't decrease.) Generation Xers also state their fears that the whole problem will be dumped on them. However, if we solve it soon, Generation X will not be stuck with the whole problem. Maybe that is the way democracies like America solves its problems - everyone is a part of the solution. The solution may have a little of everything. Forums such as this one help us to think more clearly about these tough issues, and I'm glad that they are being held all across the country. I'd also like to thank Congressman Kolbe for his leadership on this issue. The actuarial profession looks forward to working with you to find solutions that ensure retirement security for all Americans. I will be happy to answer your questions later. Thank you.

AMERICAN ACADEMY *of* ACTUARIES

Ron Gebhardtsbauer, Senior Pension Fellow

1.**Social Security has been very successful at reducing poverty among the elderly. However, the Trust Funds could be exhausted around 2034**, at which point Social Security's tax income will cover only 3/4 of the benefits (using the Intermediate Assumptions).

2.**US Budget problems come much sooner: In 2008**, when the first baby boomers reach age 62, Social Security's net income will decrease dramatically. By 2014 benefits will exceed tax income, which can quickly cause deficits.

3.**If we fix Social Security soon** while the sun is out:
a.Fixes can be less drastic than if made later (since more people are part of the solution),
b.Changes can be phased in gradually (which avoids notches),
c.We can plan ahead for the changes,
d.It will restore confidence in Social Security again.

4.**No painless options:** No option for solving Social Security's financial problems is painless. Even privatization requires increased taxes or benefit cuts. The attached page lists various options and how much of Social Security's financial problem each fixes, along with some pros and cons (also see my speech with Vice President Gore).

5.**Public Opinion:** Based on polls from Americans Discuss Social Security, the options most disliked are benefit cuts, followed by tax increases. The most favored options are:
a.**Covering new employees of state and local governments** that aren't already in Social Security.
b.**Raising the taxable wage base** quickly from $68,400 to $90,000 (or more). Even people with incomes over $100,000 opted for this over benefit cuts, although employers may not like it, because it increases their taxes.
c.**Means Test** - large benefit reductions for retirees with incomes over a certain threshold (Concord Coalition suggested $40,000 in the early 1990's, but I get the sense that people had a much higher threshold in mind). *Note: A means test can discourage saving and encourage abuse. It would change Social Security from a popular universal program into welfare.*
d.**Raising the retirement age** for full benefits was, surprisingly, next (although it had less than 50% support). Future retirees will still get benefits for more years than current retirees and we are healthier at older ages now. With shortages in the labor force in the coming decades, employers may want their older employees to stay on (at least part-time). *Note: Unless the retirement age continues to increase with life spans, Social Security will be out of balance in 20 years or so (unless automatic tax increases or automatic benefit decreases are scheduled continually into the future).*

6.**Can Social Security's surplus income be really saved?**
a.**Use it to reduce National Debt (e.g. FY1998).** Congress would have to balance the budget without Social Security. (E.g., the Social Security lock box budget rule)
b.**Invest it in private sector**. With a higher return, Social Security becomes cheaper (after an expensive transition), *but government becomes more expensive and other investors may eventually get lower returns.*
i.**Trust Funds** can get the best return and spread the risk better, but politics could affect investment decisions. Three Federal agencies already invest in stocks (Federal Thrift Savings Plan, the Fed's Retirement Plan, and the PBGC)
ii.**Individual Accounts** put more risk on individuals and have larger expenses and implementation problems. Carve-outs could force more benefit cuts. Add-ons are like a tax increase, unless voluntary. Great Britain allows voluntary contracting out of the 2nd tier, and has been fairly successful, except for sales abuses and high expenses. Their 1st tier is a flat $400/month benefit.
c.**PAYGO:** Alternatively, Social Security could return to pay as you go, by delaying reforms until 2014, when the money is needed. However, then future generations would have to pay more in taxes than the current generation, unless benefits were decreased a little more or the retirement age was increased a little more.

Proposals for Social Security Reform

(and affect on actuarial balance as % of covered pay)

Provision	Maintain Benefits (MB)	Individual Accounts (IA)	Personal Security Accounts (PSA)	Reischauer Aaron[1]	Robert Ball SS+
0. Reflect BLS changes in the CPI	✔ 0.31	✔ 0.31	✔ 0.31	✔ 0.45	✔ 0.45
1. Cover State & Local govt. Ees hired after 1997	✔ 0.22	✔ 0.22	✔ 0.22	✔ 0.21	✔ 0.18
2.a. Tax OASDI benefits like contributory DB plans	✔ 0.15	✔ 0.15		✔ 0.18	
2.b. Phase out tax thresholds on benefits by 2007	✔ 0.16	✔ 0.16	✔ 0.16	✔ 0.18	
2.c. Redirect taxes on benefits from HI to OASDI	✔ 0.31				
3. Increase benefit computation period from 35 to 38	✔ 0.28	✔ 0.28		✔ 0.25	
4.a. Increase NRA to 67 by 2011& index thereafter		✔ 0.50	✔ 0.50	✔ 0.49	
4.b. Increase earliest age to 65 and cut dis ben 30%			✔ 1.25		
4.c Keep earliest retirement age 3 years early			see above	✔ 0.23	
5. Reduce benefits above first bend point by 30%		✔ 1.32			
6. A 17 yr P/I of spouse benefit from 50% to 33%		✔ .17		✔ .17	
7. Provide 75% of couple's benefit to survivor		✔ -0.32	✔ -0.39	✔ -0.32	
8. In 1998, require 1.6% of pay contribution to IA		✔ 0.00			
9. Replace with a flat benefit of $410			✔ 3.82		
10. Eliminate the earnings test above NRA - 2003			✔ 0.00		
11. Increase payroll tax by 1.52% of pay for 75 yrs			✔ 1.42		
12. Borrow from General Fund, pay back for 75 yrs			✔ 0.00		
13. Redirect 5% of pay to PSAs			✔ -4.60		
14. Invest 40% of Trust Funds in stocks by 2015	✔ 0.82			✔(50%) 1.20	✔(50%) 1.20
15. Increase payroll tax by 1.6% in 2045	✔ 0.22				
16. Increase earnings cap to include 90% of payroll					✔ 0.58
Total (adjusted for interaction)	2.42	2.57	2.18	3.04	2.26

[1] Source: Office of the Actuary, SSA. The Social Security Advisory Council's estimates (first 3 columns) were provided 3/18/97. The estimates for the 4th column are more recent. Reischauer/Aaron recognize that they have chosen more changes than needed.

Proposals for Social Security Reform

Provision	Sen. Moynihan & Sen. Kerrey S.21	Kolbe/Stenholm HR 1793 Gregg/Breaux*	Reps. Archer & Shaw	Clinton partial proposal	Common
Reduce CPI everywhere, except SSI	✔CPI-1% **?**	**✔CPI-.33%***			2
1. Cover all new State & Local govt. employees	✔	**Gone**			1
2.a Tax OASDI benefits like contributory DB plans	**5yr phase in**				1
2.b. Redirect taxes on benefits from HI to OASDI		✔			1
3. Increase benefit computation period from 35 to:	38 yrs by 2003 ✔	40 by 2010** (35 for Spouse)			2
4.a. Increase Normal Retirement Age (NRA) to: (This doesn't hurt disability benefits)	**age 68 by 2017 using formula**	**age 67 by 2011**	stays at 67 by 2022	stays at 67 by 2022	2
4.b. Index thereafter by formula (and/or NRA) (This doesn't hurt disability benefits)	14%cut by 2066	1 month/2yrs* & **15% cut by 2044***			2
4.c. Increase Earliest Retirement Age to		**NRA - 5***			1
5.Reduce benefits above 1st bendpoint (hurts disabled)		38% by **2030***			1
6. Reduce spouse benefit from 50% to 33% by 2017		**Gone**			0
7. Provide 75% of couple's benefit to survivor		Possible Recommendation		Or something similar	2
8. Fail safe mechanism - Congressional fast track	✔	✔			2
9. Increase $72,600 wage base to **$99,900** by 2004	✔			Nadler would do	2
10. Eliminate the earnings test	✔ above NRA	✔	✔	✔above NRA	4
11. Individual Accounts (IA) # Moynihan increases tax rate after 2028 (13.7% in 2060)	2%carve out # $70B/year Optional to IA	Mandatory 2% from carve out if age < 55	2% of pay from FIT $70B/year	USA funded by FIT $38B/year	4
12. Equity Investments: IA's or Trust Funds (TF)	IA's	IA's	IA's	Both	4
13. Uses General Revenues	Kid Save $1000@birth $500@ ages1-5 lowerTaxBrackets	**~ ½ % of payroll for Trust Funds** from more Bracket creep. Lower SSI.	2% of pay for IA, returned at retirement	For Trust Funds	4
14. Progressivity	SSA benefits remain progressive	Phase In by 2010 flat min ben* = poverty level*** And Progressive Match on vol cont	progressiveSSA benefit not changed	SSA Benefits remain progressive. USA Match is Progressive	4

* Gregg-Breaux also includes KidSave accounts, lowers CPI by .5% (unless age $\geq$ 62), drops items 4b,c, &5 but offsets retirement benefits by value of ISA contributions, keeps wage base covering 86% of compensation, drops poverty minimum and replaces it with a new bendpoint of twice the 1st one & the following factors (90%, 70%, 20%, 10%) by 2016. They still allow benefits at 62.

** Allows > 40 years of earnings in numerator. Denom (40) increases with ERA. The Early Retirement Reduction increases to 8-1/3% (6% if years early > 3) by 2006. The Delayed Retirement Credit (only used from NRA to 70) increases to 10%.

*** 100% of poverty level after 40 years of covered earnings (60% at half those years). Indexed by wages after 2008

Sweden's Proposed Social Security Reform

•**Sweden's state system is like a Cash Balance plan** where contributions are indexed annually by wage growth

•The account balance at retirement is divided by an annuity using a "norm" real rate of return = 1.5% and your actual retirement age. This **encourages people to work longer**. No age limit for retirement.

•**Flexible indexation:** Benefits go up by inflation if real wages go up 1.5%. If real wages go up less, then benefits go up less than inflation. This puts more risk on retirees (especially the very old due to cumulative nature of COLAs & they can't work)

•Updated mortality tables are used so that the **system automatically adjusts for increases in longevity.**

•A pension of **60% replacement** needs 42 years of work (for someone whose wages go up by the average)

•There is a Maximum Taxable Wage Base for contributions and benefits, which is wage indexed.

•There is a **minimum guarantee = poverty level (price-indexed)**

•**Contribution**s are 16.5% currently and will increase. If wage growth is less than 2%, the system becomes unaffordable. In the bad economic years, the contribution increases = cyclical (yech).

•IA Contribution of 2% of wages goes to govt clearinghouse. Govt sends bulk checks (after 18 month lag time for identification) to private sector firms using individual allocation preferences, and charges 30 bp for this.

•Baby boomer problem is to be handled by an increase in **reserves**.

•Final decisions have not been made with regard to disability and survivor benefits and other issues!

Australia's Retirement Income System

•**Age Pension**: A flat means-tested pension of $A347 per fortnight (25% of the Male Total Average Weekly Earnings) for a single person. Each partner of a couple gets 83% of that. It is funded from general revenues. One must have 10 years of residency. 84% of aged Australians receive it, although 35% don't get all of it. No pension for those with income over $A21,000 ($A35,000 if married). Also reduced for assets above a certain level. Men get at age 65, women at 61 (which increases to age 65 by 2013). Those who work beyond NRA get a tax-exempt bonus of 9.4% of one-year's pension payment (increasing up to 235% after 5 years).

•**Superannuation Guarantee (SG):** Employment-based savings. DC minimum of 3% of earnings (increasing to 9% in 2003). There is no minimum rate of return, nor benefit minimum. Contributions & benefits are generally related to earnings. Concessional (lower) taxes apply to investment income, distributions, and additional voluntary contributions (within limits). Taxes are higher on distributions before age 55 (proposals suggest increasing this to age 60 by 2025). Rollover vehicles (approved deposit funds and deferred annuities) are encouraged for portability. Earlier efforts at encouraging employers got coverage to 72% of workers in 1991 (some employers resisted and many people were not covered by employers), so mandates were implemented in 1992. *A proposal may go in the opposite direction and allow certain low-income employees to receive their SG in cash wages. They may also require employers to offer access to a minimum of 5 funds*. SG benefits can reduce the State Tier I Pension. Must annuitize by age 75, but many use up money by then.

•**Voluntary tax-supported individual savings** encouraged by lower taxes.

Martin Feldstein Proposal *(& Archer/Shaw Proposal)*

•Everyone receives a refundable tax credit from General Revenues of 2% of taxable pay and invests it in their Personal Retirement Account. (Refundable means you receive it even if you pay no taxes.) 1st year costs = $70B.

•At retirement, the balance is annuitized or withdrawn in a series of payments. Social Security benefits would be reduced by 75¢ ***(100¢)*** for every dollar withdrawn. Thus, you are guaranteed to get your Social Security benefit (plus 1/4 of your PRA under Feldstein, which could encourage risk-taking. People may want the 75% clawback reduced. If 25% gets taxed, you only receive 15% of your PRA.) Early deaths get their PRA, not retirees.

•Deficits would return around 2015, so more taxes or cuts in government programs would be needed then. Feldstein says his proposal would eliminate deficits by 2030 (but many say his 9% investment return assumption is too high). Essentially this is general revenue financing with people doing SSA's investing. The net cost of his transfer is 25% of the money or 0.5% of payroll. SSA projections show huge increases in the deficit that future generations must pay. In addition, some people will decrease other saving, or borrow more. Thus, this proposal increases borrowing costs and decreases national savings and productivity relative to today where debt is reduced.

Individual Account Proposals

Provision (Concern)	CATO	IA	PSA	S. 1792 Moynihan & Kerrey	NCRP S. 2313 H.R. 1793	Great Britain[1]	CED
Full/Partial Privatization (Risks, Transition Costs, change, Chile)	F	P	P	P	P	P	P
Mandatory DC/DB (Vol DB creates adverse selection)	Most will opt to DC	Y/Y	Y[2]/Y	N/Y	Y[2]/Y	Y/Y	Y/Y
Contribution (May increase employer admin & investment expenses)	5% each +vol cont	1.6%	5%	1% voluntary EE cont + 100%ERmatch	2% mand +$2000 vol **with match**	1.6%EE 3%ER	1.5% each
Carve Out (hurts US budget)	Y[3]	N	Y[4]	Y	Y	Optional Y	N
Increased ER costs -hurts pension	N	Y	Y	N	N	Taxes Up	Y
Waiver for Employer PensionPlan	?	?	?	?	N	Y	Y
Employer Withholding/Payroll Deduction (enforcement, expense)	Y	Y	?	Y[5] many payees	Y	Y	Y
Government Clearinghouse-FTSP (scams,expenses,diversification)	Y[6]	Y	N	It's an option to an IRA	Y	SERPS	N
Restricted Investments (ditto)	14 Funds	Y	regs	if FTSP used	Y	a bit	Y
Pre-Retirement Withdrawals(leakage)	Y[7]	N	N	N[8]	Y if ben>povty	only after age 50	N
Mandatory Inflation-Indexed Annuity (longevity/inflation risk)	Min Ben Guartee	J&S	MRD or annuity	N	**Y or MRD up to poverty**	Y at age 75	MRD or annuity
Tax Contributions like: (US deficits)	SSA cont[9]	Roth IRA	Roth IRA	SSA Contribution	Non-deduc IRA	Switch to RothIRA?	Traditional IRA

Sen. Roth (R-DE) & Rep. Kasich (R-OH) both have proposals to use US budget surplus to create mandatory PRAs similar to Federal Thrift Savings Plan (FTSP). Roth contributions are progressive and for 5 years - no pre-retirement withdrawals. Under Kasich, 80% of the surplus

[1] **UK** Payroll taxes are progressive due to lower taxes for incomes< $400/month. The highest marginal tax rates are 20% at top wages. Tier 1 (Basic State Pension) provides a flat $400/month, no earnings test, indexed to CPI (which means it will fall behind wages). Individuals can opt out of the 2nd tier (SERPS) into a unisex occupational (DB or DC) or personal plan and receive a 4.6% of wages rebate (3% to employer if occupational plan). Some older people & those who had good employer plans who switched (10%) sued insurers for overly-optimistic yield assumptions in projections. Young can do better since the rebate is a flat 4.6% irrespective of age. Small accounts should stay in SERPS due to lower expenses. Moving NRA for women from 60 to 65 & switch to taxing up front paid for half of transition. Future costs reduced by CPI-indexation of Tier 1.

[2] Mandatory for those workers under 55. Progressive match + $150 for those with wages< $30,000

[3] Government programs are cut to avoid deficits. CATO suggested reducing or eliminating 200 government programs ($142 billion annual savings) and reducing defense by $90 billion per year. Deeper cuts are needed to avoid deficits (due to revenue losses from less FICA taxes & more pre-tax voluntary savings).

[4] Requires substantial borrowing from government & 75 year payback of 1.52% of covered payroll.

[5] Penalty on employer for non-compliance is greater of $2,500 or $100 per employee not assisted.

[6] Individuals do the investing, unless unable or unwilling, whereupon gov't is default investor.

[7] No withdrawals until account is larger than government's guaranteed minimum benefit

[8] Benefits can only begin after employee begins receiving Soc Sec benefits (or death).

[9] Voluntary withholding would be tax deferred.

is used, each person covered by SSA earning over $2,800 gets the same $ amount, taxed like traditional IRAs, and amounts can be withdrawn when they begin to receive Soc Sec benefits. No changes to SSA.

Privatization Problems and Potential Responses (which also can have problems)

Problems	Potential Responses(which also can have problems)
Low returns on current Trust Funds	Invest Trust Funds in stocks-higher returns and spreads risk
Politics could affect investment decisions	Only invest in indexes. Hire private sector investment managers to vote stocks. Make them fiduciaries & wall them off from elected officials.
A future Congress could undo these restrictions	Individual Accounts
Individuals bear **Investment Risk.** Many will get lower returns than SSA investing in stocks & will bear full risk.	Investment Education, Restricted investments, Indexes
Longevity Risk (outlive money)	Annuities
Annuities will be expensive due to adverse selection and sales charges, administrative expenses, etc	Mandate Annuities. (If everyone has to buy an annuity, then adverse selection and loading will be reduced.)
Some people (e.g., unhealthy) don't want annuities	Insurance companies could sell larger annuities (or annuities with guaranteed minimum payouts) to those with short life expectancies.
Annuities lock in market drops at retirement (Gary Burtless of Brookings: benefits would have been halved in mid-70s)	Gradually reduce stocks starting around age 55; Buy annuities gradually from ages 60 to 65; Delay retirement
Annuities to women will be smaller	Require unisex annuities
Insurers may not want to sell unisex annuities	Govt or Insurer Consortium could sell unisex annuities
Inflation Risk	Inflation-indexed annuities
Insurers will have a capacity problem (not enough inflation-indexed Treasury bonds to back up guarantees)	Treasury could issue more inflation-indexed bonds quickly, since there is much turnover in Treasuries every month
Disability Risk	Require everyone to purchase disability insurance.
Disability Insurance will be expensive for certain people	Keep the DI program in Social Security as is
Disability benefits will be too big at old ages	Reduce DI benefit by % of annuitized Individual Account
Death Risk Social Security provides insurance to a male worker with wife and kids equivalent to about $300,000	Require everyone with a spouse and/or child to buy insurance. Require J&S annuities for spouses. As with disability, it may be preferred to keep the SI program in Social Security as is (with possible reductions for benefits which can be purchased by one's Individual Account).
Divorce concerns, other women's issues	Split assets at divorce or institute Contribution Sharing.
Privatization could reduce socially adequate benefits	Keep a minimal Social Security benefit
Flat benefits can be abused (people will hide income from taxation). Could become welfare someday.	Keep some individual equity elements in the Defined Benefit portion of Social Security
Leakage concerns: individuals could spend money before retirement (or too quickly in retirement)	Prohibit lump sums and mandate annuities up to some poverty level minimum
People with bad health could convince Congress to let them have their account. Ditto for unemployed.	Still prohibit lump sums. Health Insurance, Medicare, and Unemployment Insurance could be used for this.

Early Retirement Risk (some people are retired or laid-off early)	People could prepare by saving more (or they could get another job)
Enforcement Risks	Employers can do withholding and send in with taxes
Administrative feasibility: Record keeping problems, efficiency (Currently, SSA expenses < 1% of benefits; DC plans only handle 44 million so far out of 160M)	Government Clearinghouse could handle allocations until this can be handled electronically for everyone thru Investment Management firms. Govt is default manager.
Government won't know how much someone contributed to their account until following year (February W-2 filings; April 1040 filings for self-employed)	Employers could identify by name when withheld and sent to government (similar to DOL's 401(k) allocation rules) or Govt could provide safe return until identified next year
Over 5 million employers filings are done by hand	Roth/Kasich's ideas of sharing US surplus to individuals avoid some enforcement/admin/allocation problems
Loss of income to SSA and Treasury (e.g., 2% carve out or using surplus) would force twice as much Social Security benefit cuts and FIT tax increases (higher government borrowing could raise borrowing costs to business too)	Contributions could be **add-ons** to Social Security to avoid **transition** people getting less. (Note: Only 1% of payroll is not used for current benefits)
Where will additional contributions come from? Employer pension contributions; people's other saving? Their 401(k) contributions? They'll lose their employer match.	**Allow employer plans to satisfy IA mandate**. Note: At employers where there is no pension plan now, the employer and/or employee will have to make additional contributions.
Employer plans may not be as good; employees may be currently allowed to borrow or leak their pension money; 50M temporary, PT, young, and new employees not in plans	There could be additional restrictions on employer plans that want to satisfy the IA mandate, including 100% coverage
Small accounts will get hurt with fixed expenses and low returns	Govt could prohibit flat fees and lower returns for small accounts. Govt could assist on expenses for small accts
Investment Companies may not want this business	Kasich idea gives everyone the same amount from US surplus. Or government could handle small accounts .
Any government involvement with assets could have similar concerns of politics influencing investment decisions	Complete individual control or go back to pay-as-you-go.
If stocks don't do well, people may sue government for forcing them to do this	Government could guarantee a minimum return or minimum benefit from the Individual Account.
Government guarantees could prop up/bias market, subsidize the more risky stocks, restrict business decisions	Don't guarantee IA returns. Instead, make IA voluntary (e.g., Moynihan plan).
If **voluntary**, the very people that need it won't save, and will need welfare	Make mandatory or keep Social Security as a DB plan.
Political Risks (it might not work)	Implement gradually with government involvement at first to see if it works
Income Tax loss (if treated like a regular IRA or Roth IRA)	Don't give IA tax advantages
Too many restrictions/ too much government involvement	Decide which problems above aren't important enough to fix, or keep Social Security as a pay-as-you-go DB plan.

Effects of Social Security Privatization on Employers

1.Economic and Behavioral Effects depend on type of Privatization

a. Add-On: mandatory additional contribution on top of FICA/SECA goes to Individual Account. For example, Gramlich/Twinney 1.6% Individual Account (IA) proposal and Schieber/Weaver 1.52% 75-year tax increase in Personal Security Account (PSA) proposal of Advisory Council, CED proposal (1.5% from both employer and employee), and NTU 5% add-on proposal.

i.Where does additional contribution come from?

(1)**Employer** may reduce contributions to retirement plan, if they have one. If there is no pension plan, they may have to reduce wages, reduce labor force, or corporate profits, since it is difficult to increase prices now. Voluntary IA wouldn't do this (unless match is required).

(2)**Employees** may reduce other saving. For poor who often don't save, they will have to reduce consumption. (In Chile, employers were required to increase wages to help employees contribute, but that may be unlikely to occur in the US.) Poor may have to reduce consumption. Alternatively, the Earned Income Tax Credit may be increased, which could increase deficit (or reduce surplus), require a tax increase (or stop a tax cut), etc. Voluntary IA wouldn't do this.

(3)If **Non-Highly Compensated Employees** (NHCEs) contribute less to 401(k) plan, then **HCEs** will not be able to contribute as much. Employees will lose the match, which would lower employer costs.

(4)**Allow employer retirement plans to satisfy the Individual Account mandate** (e.g., CED proposal). This could be more efficient, easier to enforce, quicker to implement. Government might place additional requirements on these employer plans, such as faster minimum vesting, 100% coverage[10], a minimum benefit (e.g., 2% contribution to 401(k) plan, or 2% cash balance minimum in DB plan, or indexing). Whether companies decline to meet the mandate, their retirement policies will be much effected.

(5)If starting in 1999, employer implements the **401(k) Safe Harbor**, then HCE's are not affected and employer match will be reduced if Non-HCEs can't afford their contributions due to Add-On.

ii.Additional savings/investments could increase prices of stocks and bonds and reduce their return in the future[11].

(1)**Lower interest rates** increase the cost of annuities

(2)Lower discount rates **increases pension funding costs and FAS87** pension costs and disclosures. (Initial appreciation could offset this for a short while.)

(3)**Reduces company borrowing costs**

(4)Increases national saving and national productivity

iii.Increases **personal responsibility** for retirement, **individual control** over investments

b.**Carve Out**: Contribution for Individual Account comes out of current FICA/SECA contribution. For example, NCRP 2% carve out proposal (recent proposals have shied away from Add-On's) and Moynihan/Kerry proposal (1% to employee and 1% to employer: If employee doesn't contribute, he/she loses match, and employer gets it. Employee's incentive is to contribute, but reverse for employer.)

i.**No free lunch:** Carve Out reduces money to Social Security and to US Unified Budget.

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[10] Including temporary, PT, young (age < 21), or new (service < 1 year) employees may be quite burdensome to employers, but is important from a policy perspective, since there are about 50 million of them.

[11] The effects provided in this outline only show direction and not magnitude. Magnitude can be great if Social Security is fully privatized or only a blip if the privatization is small and voluntary.

ii. **Social Security will have to reduce its benefits *much more*** than otherwise and must do it *immediately* in order to reduce the effect on the Unified Budget. Benefits reductions can be offset by the benefits from the IA for those who invested well, but may not fully be offset for those who don't invest well. During transition period, everyone may do worse.

iii. **Less money to US Budget** will get in the way of a tax cut, and will increase the deficit, which increases interest rates, borrowing costs, and eventually taxes and prices.

iv. **Economic effects**: **Increased interest rates** lower bond and annuity prices, FAS 87 pension expense and liabilities. Pension funding costs will go up or down depending on whether bonds or stocks are held.

v. Employers may want to **change their investment allocation rules**.

vi. **Decreases diversification**. More of our retirement benefits will depend on individual investments in the stock market (IA + 401(k) + other personal saving). Currently we are more diversified across each leg of the retirement stool.

vii. **Fate of DB plans:** Will employees like IAs and want their employers to switch to DC plans? Or will employees see that they carry more risk and go back to wanting DB plans?

viii. Will employees want employers to help them with the **other risks** too, such as inflation risk (they might demand that their employer's DB plan benefits go up with inflation), longevity risk (they may want 401(k) plans to offer annuities), larger LTD benefits and more life insurance at young ages?

ix. If stock market crashes, employees may want to **delay retirements**.

x. Individual Accounts may encourage later retirements (i.e., older workforces), since they have no subsidy in them for retiring early, unless employer provides supplements at early ages (which is expensive).

c. **Investing Trust Funds in the Markets**

i. Trust Funds will probably get a **higher return**. Funds will be saved outside government, which could reduce arguments about whether government really saves the money.

ii. **Increases deficit** (or reduces surplus and chance for a tax cut), increases interest rates and borrowing costs, and eventually increases federal income taxes and prices.

iii. Thus, Social Security becomes a better deal, but other things become a worse deal. I'm not saying whether that is bad or good.

iv. **Politics** could influence investment decisions (unless private sector investment managers vote the shares and indexes are used - a future Congress could undo those restrictions) which could affect companies. Aren't companies already affected by politics? (E.g., tobacco)

v. **National savings and productivity** may not increase much, since owners of stocks that are bought out for a higher price, may then be willing to invest in bonds (which now have a higher return). I.E., Initially it's a **wash or zero sum game**, unless someone has to reduce consumption. Eventually, if taxes are increased[12], consumption is decreased, and national savings and productivity increases.

vi. **Increased interest rates** lower bond and annuity prices, FAS 87 pension expense and liabilities. Pension funding costs will go up or down depending on whether bonds or stocks are held.

vii. Employers may want to **change their investment allocation rules**.

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[12] Actually, Congress wouldn't have to increase taxes, if they included the Social Security stock holdings as an asset of the government and thus inside the Unified Budget. Then they wouldn't have a deficit in the Unified Budget. They might claim this since they could correctly point out that the stocks are available to pay benefits in the future.

2.**Government guarantees** of minimum returns (Mark Sanford, R-SC) or minimum benefits (Phil Gramm, R-TX and Domenici, R-NM). Chile also does this.

a.Could **cost** the government more, which increases the deficit, interest rates, borrowing costs, and eventually taxes and prices

b.If government charges investor a **risk premium** (Mark Sanford) depending on the investments, government may want to investigate these risks (companies) before setting the premium and reduce these risks from happening (which could involve the government in corporate decision-making, since government would be on the hook for the loss - see PBGC history)

c.**Subsidizes risky stocks, junk bonds**, companies, foreign investments, start-ups, emerging markets, derivatives, poor investors, etc.

d.People would be less likely to invest in strong, mature companies, and bonds, so they would have to offer higher returns to get investors. **Good investing techniques could be shunned.**

3.**Implementation Details**

a.**Collection:** Many proposals require employers to collect the IA contribution from employees and send to government clearinghouse. Some (e.g., Moynihan/Kerry, CED, NTU, and PSA) require employer to also send contribution to fund(s) of employee's choice. CED proposal would limit the number of funds.

i.**Moynihan/Kerry's penalty** for non-compliant employers is the greater of $2,500 or $100 per employee not assisted.

ii.If some employees don't like investment alternatives, or high expenses on small balances, or need money, they may work with employers to find ways around mandates.

iii.If employer makes a mistake (forgets some employees), they could be sued (in addition to having to pay the fine).

iv.The **Roth and Kasich proposals** avoid this collection problem (because they just divvy up the US budget surplus), but have other problems.

b.**Identification of contributions:** SSA won't know the amount of one's contribution until W2 is filed in February of the following year. (For self-employed, they won't know until 1040 is filed April 15 of following year.) Employers may have to provide individual breakdowns each pay period when the money is sent in, similar the 401(k) asap allocation rules that DOL put out recently. Otherwise, Social Security won't know how much money is in someone's account. Suppose someone wants to get out of the stock market and SSA doesn't know how much to move out? Suppose SSA keeps it in a default stock fund and can't move it? Or a low yielding money market fund? Remember, this is money that people have been forced to pay to SSA.

c.**Allocation:** The government could allocate the assets as per the individual's request. Frank Cavanaugh (former head of federal employee's Thrift Savings Plan) says government would need 10,000 employees to handle the phone calls. This could be reduced if individuals provided their allocation elections electronically by phone or PC. Alternatively, employers could perform the allocations and may be asked to help in the investment education of their employees. If individuals make the payments and allocate them, there could be an enforcement problem (unless the system is voluntary). One solution would be for employer to put into a **govt holding fund**, which individuals must empty by sending to an investment manager or fund.

d.**Waiver:** It might be easier and cheaper for employer to just put into the company 401(k) plan, or any plan qualified to waive the mandate.

e.**Survivor and Disability Benefits:** will they stay in Social Security, or will employers have to provide more benefits in these areas?

4.**Permitted Disparity**:

a.Will employers be able to **offset their retirement benefits** by the benefits from the IA? What if the IA is not distributed in a single life annuity? What if IA is voluntary? An easy answer may be unattainable, so permitted disparity may be reduced or eliminated.

b.Employers may want to **offset their survivor and disability** employee benefits by the amounts payable from the IA, if taken in annuity form. What if they aren't paid in annuity form?

5.**Leakage:** If individual gets lump sum from a fully privatized system before retiring and spends it, they may be difficult to retire unless employer provides a much better pension or lays them off.

6.**Taxation:** PSA proposals treat the Personal Security Account like a Roth IRA for tax purposes. Their distributions are not taxed at all, which would reduce US tax income in the future. This could force US to increase taxes in future.