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Can the Stock Market Rescue Social Security?

Part II, The Proposed Reforms

As discussed in the previous issue of *Research Reports*, Social Security faces mounting financing problems when the baby boom generation begins to retire in 2010. Last month, a Federal advisory council issued a report recommending changes in the system. The panel's 13 members could not reach a consensus and instead presented three separate proposals. While radically different in their scope and potential effects, all three plans share in common a strategy to invest some Social Security payroll taxes in securities other than U.S. Treasury bonds, the only investments permitted under current law. These plans are described below.

Plan 1: Maintenance of Benefits

The first plan would preserve Social Security's tax and benefit system largely as it is. The program would remain a "defined benefit" plan, under which an individual's retirement benefit is based on his earnings. However, future benefits would be curtailed slightly by changing the method used to calculate lifetime earnings — instead of basing benefits on the 35 years of highest earnings, 38 years would be used. To raise the necessary revenue, all new state and local government workers would be required to participate in Social Security. In addition, all benefits in excess of an individual's previously taxed payroll contributions (*i.e.*, in excess of the employee's share of payroll taxes) would be subject to income tax, in contrast to the current law which taxes 50 to 85 percent of benefits received by taxpayers above certain income thresholds. All of the income tax revenue thus raised would be used to finance Social Security, instead of the current practice of using a portion to finance Medicare. (The proposal does not say how Medicare would make up the shortfall.) The plan also calls for raising the payroll tax by 1.6 percentage points beginning in 2045.

In addition, a portion of the Social Security Trust Fund would be invested in the stock market. Eventually about 40 percent of the Trust Fund would be invested in U.S. and global market indexes. These indexes, and the Fund's overall investment portfolio, would be selected and monitored by an investment policy board appointed by the President. The hope is that the investment returns on equities will be sufficiently high to maintain the benefits promised under current law without raising taxes for another 50 years.

What would happen under this plan if the Trust Fund's investment portfolio did not perform as well as projected? The Fund would fall out of actuarial balance, as the Government defines it. Whenever this has happened in the past to Social Security or Medicare, the response usually has been to raise taxes or cut benefits. On the other hand, such actions might not be necessary if the stock market did better than expected. Indeed, if the stock market boomed, it might be possible to cut taxes or increase benefits. Both possibilities suggest a major concern about making Social Security's finances dependent on the stock market. Economic and monetary policy would face even more pressure than they do now to keep the economy and the financial markets perpetually booming.

Another problem with this proposal is that putting billions of retirement funds under Government management would partially nationalize American enterprise. This aspect of Social Security reform was discussed in detail in the April 1, 1996 issue of *Research Reports*. As envisioned in this plan, a small group of unelected bureaucrats would decide how to invest billions of tax dollars. Although their charter supposedly would be limited to the fiduciary role of selecting the best investments for workers and beneficiaries, it is not hard to imagine their decisions being influenced by other considerations. Suppose the Trust Fund held stock in a company that was sued by its employees for sex and race discrimination. How would the supervisors of the fund respond to the inevitable demands that it divest its shares? Would a Government-owned and managed fund hold tobacco stocks, or stocks in companies that sell products made by cheap labor in China? Concentrating so much power in the hands of a few would invite political meddling in investment decisions.

Another drawback of this plan is that it would require an increase in general taxes or Government borrowing. It does not explicitly call for either. However, if surplus payroll taxes were invested in the stock market rather than special-issue Government bonds, as the plan recommends, the Treasury would lose a source of revenue. In addition, if some of the bonds now held in the Fund were redeemed in order to invest the proceeds in the stock market, the Treasury would have to raise revenue to pay back principal and interest. Either taxes would have to increase, or the deficit would increase, or spending on other Government programs would have to be cut.

Plan 2: Publicly Held Individual Accounts

The second plan would cut the traditional earnings-based benefit paid to future retirees, by extending the benefit computation period from 35 to 38 years and by raising the age of eligibility for full benefits to age 68 by the year 2011 (instead of 2027 as now scheduled) and tying it afterwards to increases in overall longevity. Additional changes in the benefit formula would make it more progressive, which would further reduce benefits mainly for middle and high wage earners. Even with these changes, the program would require additional revenue, which would be raised by increasing taxes on benefits and bringing state and local government workers into the system.

The scaled-back basic benefit would be supplemented by a benefit financed by compulsory savings accounts. These accounts would be financed by a 1.6 percentage point increase in the payroll tax paid by employees. The revenue would be collected and managed by the Government, but each worker would have a sepa-

rate account held in his name. The individual would decide how to invest it, but his choices would be limited to stock and bond index funds selected by the Government.

Any time after reaching age 62, the individual could elect to convert the accumulated value of his account into a stream of annuity income. If he died before retiring, the fund would pass to his estate, but if he died after annuitizing, his survivors would receive only a small payment, perhaps one year's annuity income. Married retirees would have the option of choosing a smaller annuity that, in the event of their death, would continue to be paid to the surviving spouse.

Annuitizing would be the only option for withdrawing funds. This restriction presumably is intended not only to assure a steady income until death, but to eliminate the possibility that short-sighted retirees would draw down their savings accounts too fast. There would be considerable pressure for the Government to bail out such people by giving them additional benefits.

In contrast to the first proposal, this one puts much of the responsibility for investing with the individual rather than the Government. If an individual's investments did well, he would be entitled to a higher annuity income, but his annuity would be smaller if his investments did poorly. An important question is whether the Government would bail out individuals whose investments did not do well. Especially since these would be Government-mandated accounts invested in index funds chosen by the Government, there would be considerable political pressure to do so.

Political forces might also influence the annuity income rates offered to retirees, if they were set by the Government rather than private insurers. Among other things, there would be pressure to provide inflation-indexed annuities, which few private insurers offer. On the other hand, if the annuities were sold by private insurers, there would be pressure to bail out annuitants if the companies failed. In addition, this plan raises some of the same concerns about the Government's role in the financial market as the first proposal. These include the political and economic implications of having the Government choose the investments available to workers, and tying a huge mandatory savings and entitlement program to the fortunes of the stock market.

Plan 3: Privately Held Personal Security Accounts

The third proposal is the most radical. It would shrink the traditional Social Security benefit the most, mainly by phasing out the current system of earnings-based benefits and eventually substituting a flat dollar benefit for all retirees equal to $410 in today's dollars.

This basic benefit would be supplemented by an individual savings account. These would be funded by diverting five percentage points of the employee share of the payroll tax (which currently totals 15.3 percent of taxable earnings). Unlike the second proposal, these accounts would be held and managed by individuals rather than the Government, and investment options would be less restricted — much like IRAs now operate. Upon reaching the retirement age (which would be raised in the same manner as the second proposal), individuals would not be required to annuitize but instead could take withdrawals however they want. Any funds remaining upon death, before or after retirement, would go to an individual's estate.

The plan would also eliminate the retirement earnings test (which reduces benefits for retirees with earnings above a certain amount). In addition, benefits would be subject to new income tax treatment and new state and local government workers would be brought into the system, the same as the other proposals.

The transition from the current system to the two-tiered benefit plan would take a long time. The system of taxes and benefits would remain roughly the same as it is now for workers age 55 or older. Only workers currently under age 55 would invest a portion of their payroll taxes in savings accounts. Workers aged 25 to 54 would eventually get a benefit based partly on their earnings and partly on a pro rata share of the flat benefit, plus the funds accumulated in their personal savings accounts. Workers currently under age 25 would get only the flat benefit plus their savings accounts.

The main advantage of this plan is that it gives individuals the most control over their investments. Although the accounts would be subject to regulation, much as IRAs now are, there would be less potential for political interference with investments than with the other two plans. In addition, by shrinking the guaranteed benefit to a floor of support, it does more — over the very long term, after it is fully phased in — to alleviate the financing problems of pay-as-you-go Social Security.

The major disadvantage of this plan is its cost in the "shorter" term — the next 50 years. Because the flat benefit would not be fully phased in until 2040, well after the last baby boomer retires, this large demographic group would be entitled to larger benefits. However, the diversion of 5 percent of payrolls into savings accounts would reduce the available revenue. The plan would raise the extra revenue either by increasing the payroll tax by 1.52 percentage points or by taxing consumption. The plan recommends the latter, on the theory that it would encourage savings and shift more of the financing burden to retirees. In addition, it calls for a huge increase in Government debt over the next 40 years, equal to $1.9 trillion in today's dollars.

Although this plan comes closest to "privatizing" Social Security, it does not entirely return responsibility for planning their financial futures to the younger people most affected by it. It forces them to save for retirement, rather than allowing them to spend or invest their earnings as they choose. Many young workers would probably prefer to save for a down payment on a house, pay back student loans and other debts, buy a car, take a vacation, etc. Full "privatization" would allow individuals to decide not only how to invest their retirement savings, but how much (if anything) to save for retirement. The risk, of course, is that people would not save enough and the Government would end up paying for their retirement anyway - but if their expected benefit were small, it is likely that most people would try to save additional funds, as they do today. People could be encouraged to save, rather than forced, by adopting tax policies that make saving more attractive than spending. One possibility would be to replace the current income tax system with a consumption tax.

Critical Assumptions about the Stock Market

All of the plans project that benefits under the reformed Social Security program would be the same or better, on average, as those provided by the current system. However, to achieve this happy outcome, they rely on some dubious assumptions, particularly regarding investment returns. All three plans assume that the average real rate of return on stocks and long-term Government bonds will be the same over the next 75 years as they were during the period 1900-1995. According to the council, stocks provided a real annual return of 7 percent during this period and bonds provided a return of 2.7 percent.

While the precision of these projections implies that a reasonable degree of confidence in them is warranted, they amount to little more than fantasy. There is little basis for expecting securities to provide the same return in the future as they did in the long-term past. In particu-

The Outlook and the Genuine Issues

There are several inescapable conclusions that can be taken from the Federal advisory council's report and recommendations on the changes needed to "save" the Social Security System. All three of the plans call for:

1. Curtailing future benefits via later retirements, increased taxation of benefits, revising the formulas downward for middle and upper income workers or some combination of these.
2. An increase in the amount to be taken out of workers' paychecks that is designated for their retirement (Plan 1 postpones this until 2045).
3. Placing a portion of the earmarked funds in private financial assets (stocks and non-Treasury debt obligations).

No. 1 is a virtual certainty. Delayed retirements are already written into the law, and it is likely that further postponements and other tax and formula adjustments will be made sooner or later. No. 2 is less certain in its particulars, but the outlook for taxpayers is not good. No. 3 could make that outlook even worse.

Funds used to purchase private financial assets for the Social Security Trust Fund (as under Plan 1) will reduce what the government has for other purposes. This will be so even if the private financial assets are to be held in individual accounts (as in Plan 3) — the Treasury will still have to borrow, or raise in taxes, equivalent amounts to pay currently promised benefits.

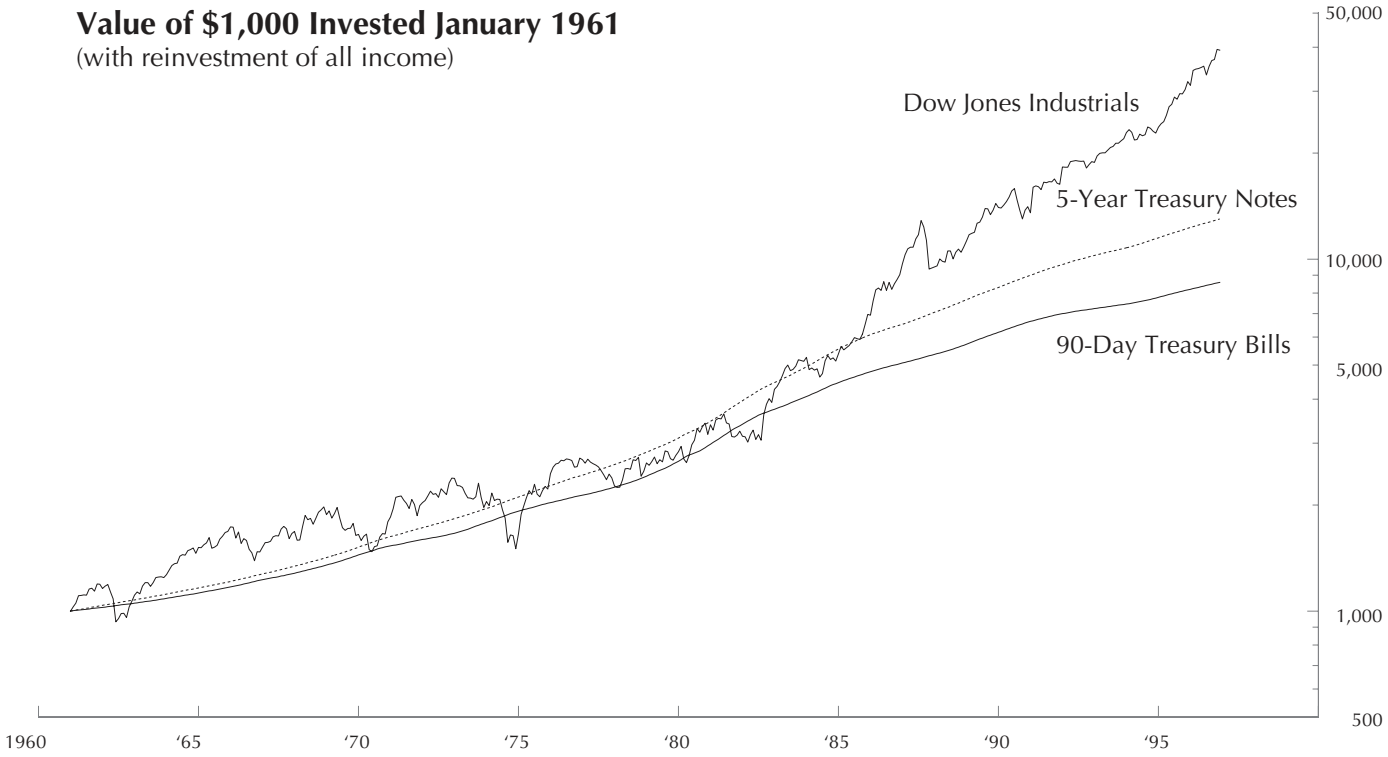
That last point is completely lost on those who assert the Social Security Trust Fund somehow serves to stabilize the tax burden of paying benefits or that it serves to protect or guarantee benefits. The notion of putting some Social Security funds in the stock market reflects the hope (and it is only a hope) that the returns on those private financial assets will eventually serve to curtail the "pay-as-you go" tax burden of supporting retirees. Yet, even if some of future retirees' benefits are funded with private financial assets, the Treasury will still face the need to find the huge sums needed to pay currently promised benefits while it waits for the pay-offs. That need will only be exacerbated by using funds to "play the market" rather than to pay benefits.

A similarly misguided notion is that "funding" Social Security with private financial assets will increase the Nation's savings rate, boosting economic growth and enabling us to afford to keep the elderly in the style to which they have become accustomed. Under plan 1 and plan 3, the Treasury will be taking the same amount from the capital markets as Social Security is bringing.

Even plan 2, which calls for putting 1.6 percent of earnings in individual accounts over and above the existing payroll tax (in the expectation that the returns on those investments will make up for reduced benefits) would only increase the savings rate to the extent that workers maintained their current savings rates after the additional 1.6 percent was taken out of their paychecks.

More to the point, we have long argued that the savings rate is only part of the problem of capital formation: the nature of the capital formed may be even more important. A mandatory diversion of hundreds of billions into the securities of well-established business would surely restrict to some extent the funds available to the most dynamic enterprises — the small businesses and the new ventures that have been the source of most of the growth of output and employment.

The fundamental issue, however, is whether the Government should continue to operate a "pension plan" designed to provide substantial incomes (*i.e.,* more that a basic subsistence). The current system is clearly untenable. Without major changes, it will eventually make most workers poorer than the retirees they have to support. A related issue is whether the government has any business forcing an individual worker to give up current consumption to pay for retirement income of a specific amount, when the worker may have other preferences on how to allocate his or her lifetime consumption.



lar, massive flows of Social Security revenues into and out of the markets could have a significant, if unpredictable, impact on the financial markets, the economy, and savings behavior. In addition, there have been prolonged periods when the return on stocks and bonds was higher or lower than the long-term historical average. The accompanying chart shows the value of an initial investment of $1,000 in 1961 in three investments — the Dow Jones Industrials Average (with dividends reinvested), 5-year Treasury bonds, and short-term Treasury bills. In addition to being volatile from one year to the next, returns have been relatively higher during some long periods than during other long periods (for example, the Dow stocks since 1980 vs. the Dow stocks in the preceding 15 years).

The chart also calls into question the assumption that stocks will outperform bonds, thus providing the extra returns needed to finance projected benefits. They have not always done so — indeed, there have been long periods when the returns on stocks have not been superior. For roughly 25 years, from 1961 to 1985, the total return on stocks and 5-year bonds was roughly the same. For the 20 year period from 1961 to 1981, the total return on stocks and Treasury bills was about the same. Only during the past 15 years or so have stocks outperformed Government securities.

The uncertainty and volatility of investment returns has significant implications for all three reform plans. Under the first plan, the Government would directly bear the investment risk — it would be relying on investment returns to help finance the current program and would have to turn to other sources of revenue to make up any shortfall. Under the second plan, the size of the annuity that a person could purchase upon retirement would depend on the value of his accumulated savings. Under the third plan, the value of a retiree's personal savings account would vary during his retirement, unless he opted to buy an annuity. The question of how the Government would deal with people whose investments did not do well, or who made poor investment choices, under either of these plans is a fundamental one that, unfortunately, was not addressed by the advisory council.

There Are No Easy Answers

That the council's proposals rely on tax increases, more Government borrowing, or high investment returns to finance Social Security underscores that it is too late to make an easy transition from a pay-as-you-go system to a prefunded one. The unfunded liability of the current system is huge. Trillions of dollars in benefits have been promised to people who have been paying into the system for years, including the large baby boom generation, and there is nothing backing these promises except the Government's power to tax and borrow in the future. Requiring workers to start saving for their own retirement will not reduce this liability. It may prevent it from getting bigger, but it will not reduce it. Cutting benefits will reduce the liability but not eliminate it. During the transition to a prefunded system, future workers would still have to pay for two retirements — their own and that of the previous generation of workers.

The best hope for reducing the financial strain is reduce benefits, along the lines recommend by the plans, and to pursue policies that will increase the nation's wealth. In this respect, policies that encourage individuals to save and invest through market processes are preferable to those that would centralize control over savings or invite political interference in the financial markets. ❑

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