

THE COMING CRISIS IN SOCIAL SECURITY

by Dr. John B. Shoven,

Charles R. Schwab Professor of Economics and Dean,
School of Humanities and Sciences, Stanford University

[Editor's Introduction: The mutual fund industry and its national association, the Investment Company Institute, have long supported efforts to enhance personal savings in this nation, as savings provide a foundation for sound retirement planning as well as a healthy economy. Dr. John Shoven has made an important contribution to the public policy debate on Social Security reform. Here, he offers an analysis of the impending retirement crisis, makes a compelling case for early planning to restore long-term solvency to Social Security, and proposes sensible solutions. These proposals include various modifications to the current system to permit workers to invest a portion of their payroll taxes in private investments as a means of generating higher retirement benefits. The Institute is pleased to publish Dr. Shoven's recent remarks to its Board of Governors on this topic.]

Summary

As most of you know, the Social Security system is now the largest federal government program, having recently passed the Defense Department in size. Most workers pay more Social Security taxes or contributions than they pay personal income taxes; for most elderly, Social Security is their dominant source of income. Thus, you have a program that is incredibly important to many people, and, like anything important in your life, it makes sense to get a periodic check-up to see how it's doing. So that is really the nature of this talk—a check-up.

I don't think I'm giving away too much by saying there are plenty of dismaying things you discover when you begin to look at Social Security. That's why I call this talk, "The Coming Crisis in Social Security." This is not meant to be alarmist; in fact, the forecasts I rely on are the official forecasts of the Trustees of the Social Security Administration.



Perspective is a series of occasional papers published by the Investment Company Institute, the association of the American investment company industry.

I've divided my remarks into five sections. First, I'll remind you of the nature of Social Security: how it works, how retirement benefits are calculated, and so forth. Second, I'll get into what the problems are, what the coming crisis is all about. Third, I'll talk about a key feature of the crisis: the fact that we have fairly dramatic demographic changes going on in this country, most notably the baby-boom generation is getting older and approaching retirement. Fourth, since the aging of the population is occurring in nearly all advanced countries in the world, I'll look at how other nations are dealing with this same phenomenon. Others are far ahead of us in addressing their aging societies and we might learn by examining what a few of them have done. Finally, the fifth section will identify two or three different alternatives for us, looking at how much we would have to change Social Security to deal with the retirements of the baby-boom generation.

I. The Nature of the System: Inter-generational

As you're all aware, Social Security is primarily a pay-as-you-go system. That means that each generation of workers makes contributions to the Social Security Administration, which in turn immediately sends most of that money out to retirees. Social Security has a small trust fund—and it's going to grow—but it will never be anywhere near enough to cover the system's liabilities to participants. Now when you have a pay-as-you-go system like this, the first generation of retirees does very well. The workers start putting their money in and the government starts paying out retirement benefits. The initial retirees, who did not contribute anything to the system, receive a large windfall gain. In fact, as you scale up the system, several generations may do very well. While they work, they contribute a small amount, but when they retire, they get benefits based on the contributions of the current working population, who are paying a lot more.

If you look at the combined employer/employee contribution rates for retirement benefits, you can see the scaling-up effect. The combined rates were 2% in 1940, 3% in 1950, 6% in 1960, 10% in 1980, and 12% since 1988. The amount contributed has gone up and up and up, and current retirees have done well because when they retire, they get a larger fraction of workers' salaries than what they put in themselves. In addition to these percentage increases, the wages on which the contributions are based have gone way up—that is, the maximum income on which the contributions apply. Of course, this scaling up can't continue forever. In fact, there is little discussion of raising contribution rates further.

How is your Social Security retirement benefit calculated? Here is the simplest possible explanation; it obviously omits some of the details. In order to calculate how much a retiree gets, the first thing the Social Security Administration does is compute the person's average indexed monthly earnings for the 35 highest years of earnings. The indexing brings previous earnings up to date using an economywide wage index. In order to receive any benefits, you must have at least 40 quarters (or ten years) of covered earnings. Once the average indexed monthly earnings (AIME) is calculated, your retirement benefits are computed. The first step of this computation is to figure your primary insurance amount (PIA) using a three-part formula.

The three-part formula goes as follows: (a) the primary insurance amount equals 90% of the first \$432 of a worker's average indexed monthly earnings, plus (b) 32% of the next \$2,173 of AIME, plus (c) 15% of the AIME exceeding \$2,605 (\$432 + \$2,173). The PIA is how much a single person retiring at age 65 would get. A married couple gets 1.5 times that amount. If they retire at a different age, they get some percentage of that PIA. For example, if a single person retires at 62, he or she gets 80% of the PIA. Social Security retirement benefits are indexed for inflation and annuitized for life—two key features. As you know, there aren't many, if any, inflation-indexed life annuities in the private market.

As a result of the way retirement benefits are calculated, there is actually a very weak connection between what you pay in and what you get out of Social Security. For many people, if you pay in more, you don't get any more out. For instance, if you work more than 35 years, your additional contributions may not raise your benefits. If you're the secondary earner in a household, you may not get anything for your contributions because spouses get a spousal benefit which may be more than what they would get based on their own earnings. Even for many of those whose contributions affect benefits, the present value of what they get out for an extra dollar paid in is about 15 cents. At the margin of working a little more and contributing a little more, you don't get much. So, even for these folks, contributions probably look more like taxes than like deferred compensation.

Because of this weak connection between what a worker pays in and what he or she receives, economists have a hard time knowing how to treat Social Security contributions. Should we treat them as taxes or should we treat them as deferred compensation? If the connection were stronger, treating them as deferred compensation would make sense; but the weak relationship argues for characterizing the contributions as taxes and the benefits as transfer payments.

As it now stands, the system imposes a huge net liability on future generations. Look at today's adults—let's say, everybody over 21 years old—and ask how much will they get out of the Social Security System as it's currently legislated. If you take the present value of their future benefits and subtract the present value of their future contributions, you get \$11 trillion. That is—if today's system could stay in place, today's adults would get \$11 trillion more from Social Security than what they will pay in from now on.

How can this be? Think of today's retired population: they're not going to put any more in; they're currently getting benefits and will continue to get them. Think of today's 55-year-olds: they're going to put a little more in; then they get all of their retirement benefits. The present value of their benefits minus the present value of their future contributions is a big positive number. For all of today's adults, it's an \$11 trillion asset. Of course, that \$11 trillion asset is an \$11 trillion liability for future taxpayers, amounting to approximately \$50,000 per person in the U.S.

As it now stands, the system imposes a huge net liability on future generations.

Here's another perspective on that \$11 trillion. U.S. public *and* private pension fund assets together amount to something like \$5 trillion. So the Social Security liability is more than twice the size of all other pension fund assets. Against \$11 trillion worth of claims, the Social Security trust fund has \$400 to \$500 billion in assets at the moment. So in some sense Social Security looks bankrupt—it doesn't have the assets behind the claims against it—but of course it can work as long as future generations keep paying in, hoping that succeeding generations will pay in even more. The system is akin to an inter-generational chain letter.

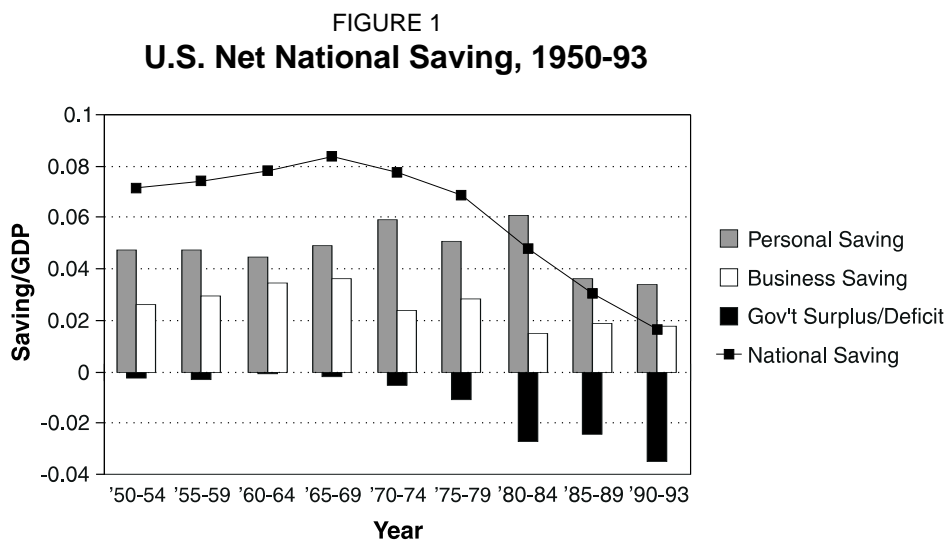
Now, let's assume we privatize. Social Security is gone, everybody pays for their own retirements in IRA or 401(k) type accounts. The question is: What are we going to do about the benefits for the current retired people? Or the people who are near retirement? Or the people who think of themselves as "into" the system, in whatever sense? The obligation to these people is the transitional problem—and it's an \$11 trillion problem. Who is going to pay these people if today's workers are now paying for their own retirements instead of paying for the retirements of older generations? Currently, we've got an inter-generational scheme where each generation pays for older generations. If we suddenly switch to a plan where each generation pays for its own retirement, who is going to pay for the retirements

of today's older generations? The tough part of reforming Social Security is dealing with the transition from the existing system.

II. The Problems with Social Security

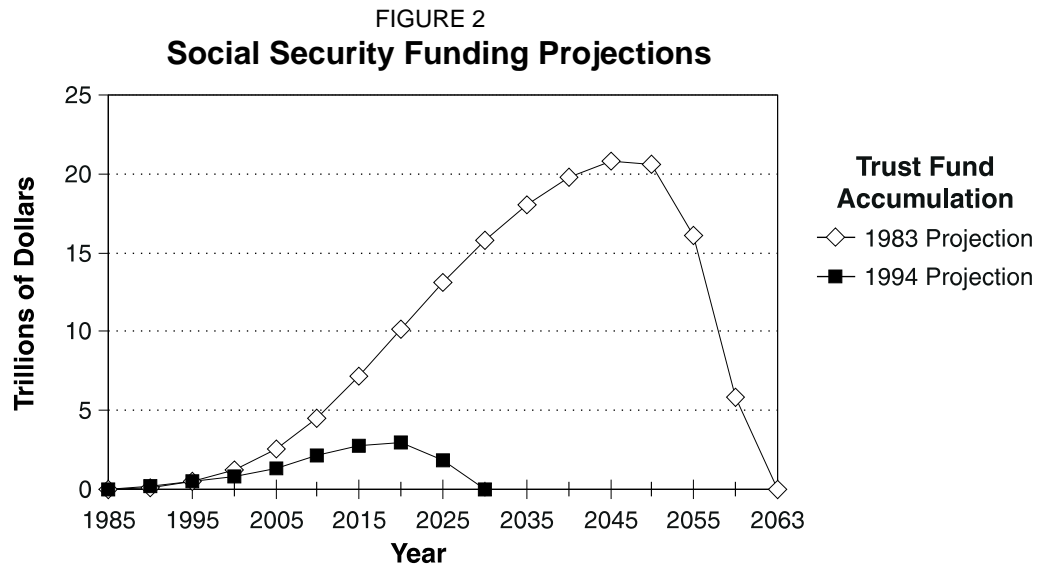
A. Negative Impact on Saving

Problem number one is that Social Security looks like an \$11 trillion asset and yet there's really nothing—or almost nothing—behind it. The entire economy has about \$17-18 trillion of tangible wealth, so \$11 trillion is $\frac{2}{3}$ of the tangible wealth of the country. If you are a middle-class worker and you are told that Social Security will replace half of your income when you retire, you're going to save a lot less than if Social Security weren't there. How much does Social Security depress saving? A lot of studies have looked at this issue, and I think it's fair to say they have not reached conclusive scientific results. But the best estimate is that each dollar of Social Security "quasi-wealth" probably displaces somewhere between 50 cents and a dollar of real saving. Society saves a lot less because of Social Security. If Social Security were smaller, we would be wealthier, the economy would be stronger, and wages would be higher.



Source: U.S. National Income and Product Accounts

As Figure 1 illustrates, the saving rate in the United States has been declining and is currently somewhere in the 2 or 3 percent range. That is low by historical standards and low by international standards. Saving is a concern and Social Security probably contributes to the low rate of saving in our society. So that's problem number one.



Source: 1983 and 1994 Social Security Trustees Reports

B. System Isn't Financially Viable

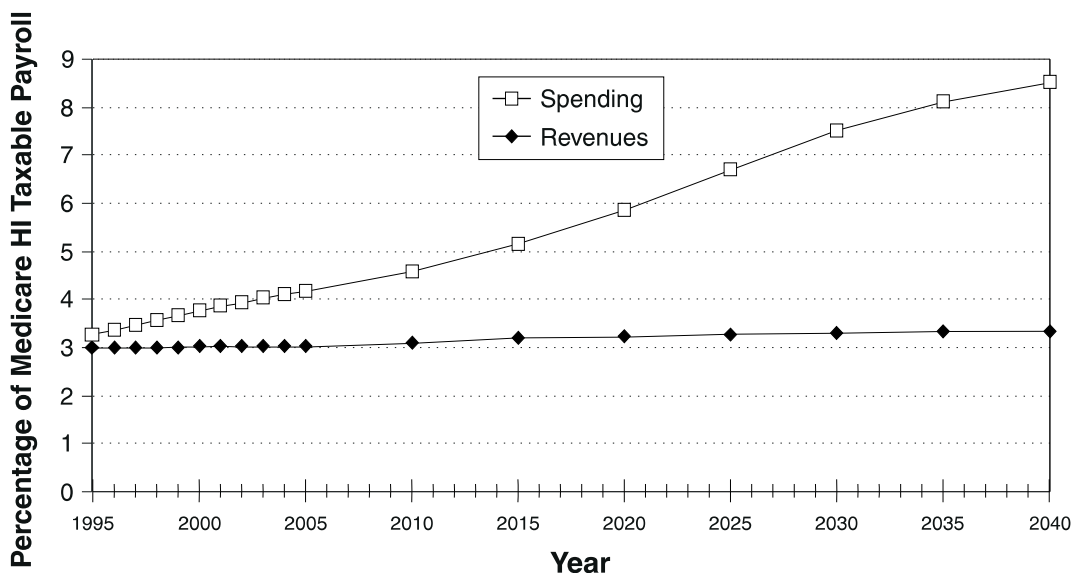
Problem number two is the *big* problem. The current system simply isn't financially viable. The Social Security Trustees would say something like the system isn't close to actuarial balance, which is another way of saying it is bankrupt. In 1983, Alan Greenspan led a commission to fix Social Security, which even then was believed to be on shaky financial ground. The Commission made a number of changes, including advancing the retirement age, in an attempt to build up a trust fund sufficient to pay for the retirements of the baby-boom generation. They projected that, in nominal terms, the trust fund would hit \$20 trillion (see Figure 2) before being liquidated to get the baby-boom generation through retirement. The last of the baby boomers were born in about 1963. The Greenspan Commission thought they had the system fixed so that it would be solvent through 2063, when the youngest boomers would be 100 and presumably there would not be many of them left.

Fast forward to 1994. Figure 2 also shows the official trustee projections now. The current projection is that the system will not accumulate \$20 trillion in assets, but rather something less than \$3 trillion. The trust fund begins to decline in about 2018, and by 2030, the system runs out of money. In 2030, how old are people born in 1963? They are precisely 67 years old and that is exactly when they become eligible for full Social Security benefits, but Social Security will not be there to pay them (unless the system is changed or the official forecasts are wrong). So, the latest forecast for Social Security is that it cannot fund the boomers' retirements.

I want to make one point here with respect to Medicare. So far, we've been concentrating on the retirement portion of Social Security. The Medicare

In 2030, how old are people born in 1963? They are precisely 67 years old and that is exactly when they become eligible for full Social Security benefits, but Social Security will not be there to pay them (unless the system is changed or the official forecasts are wrong). So, the latest forecast for Social Security is that it cannot fund the boomers' retirements.

FIGURE 3
Medicare Funding Projections



Source: 1995 Social Security Trustees Report

portion of Social Security is in even worse shape, if that's possible (see Figure 3). Medicare goes broke—its trust fund runs out of money—in 2002. But that's just the tip of the iceberg. As the baby boomers get older, Medicare costs will really go through the roof. The Medicare problem today is tiny compared to the problem it will pose 15 or 20 years from now. So as you can see, any solution to the retirement problem which involves raiding the Medicare trust fund is nuts. The Medicare trust fund is in substantially worse shape than the retirement trust fund and its demise is much more immediate.

C. Voter Bias

The third and final problem I'll mention is an interesting political science problem. The average voter is biased on the issue of Social Security. Imagine an initiative on the ballot that would raise Social Security contributions 50 percent and raise Social Security benefits 50 percent. Remember how the system works: the first part of your life you pay in, the last part you get money out. Now think of a 63-year-old voter. He or she says, well, I've only got a couple more years to pay in and then I'll get all those benefits; a 50 percent increase sounds like a good deal to me. Of course, any 65-year-old voter will say it's a good deal. Any 55-year-old voter will think it's a pretty good deal. The point is the average voter is well into the system, having already paid $\frac{1}{2}$ to $\frac{2}{3}$ of his or her contributions. So even though Social Security rates of return are low on a lifetime basis, they may not be so low on a "looking-ahead" basis. For instance, when baby boomers look ahead, they see all of their benefits, but only about half of their contributions. The only unbiased voter would be a 21-year-old, with the whole system ahead—all the contributions and all the benefits. But for the average voter, scaling up the system looks pretty good. This problem may explain why we have a larger system than is socially desirable.

III. The Demographic Challenge

Sometimes when you're driving along, you see a sign that says sharp curve ahead. That's what we've got in terms of U.S. demography: sharp curve ahead. We'll see dramatic change for two reasons: first, birth rates have been cyclical—a baby boom followed by a baby bust—and second, mortality has improved more rapidly than most actuaries expected, including the Social Security actuaries. Combine these two factors and you'll see a sharp increase in the size of the elderly population relative to the working population. Right now, there are about 3.2 workers for every retiree. This number is projected to fall below 2, maybe to 1.9 workers per retiree. That's a huge problem for a pay-as-you-go system. You don't have enough workers for each

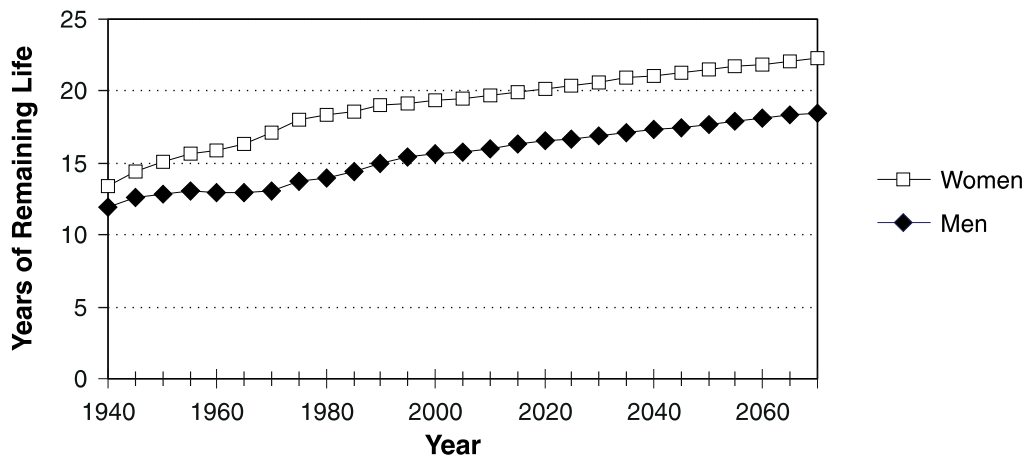
retiree, without high tax rates and lots of pressure on the system. This demographic problem is shared by many other countries, a point I'll return to later.

People are not only living a lot longer, but life expectancies are lengthening faster than anticipated. Figure 4 shows that, in 1940, a 65-year-old man could expect to live about 12 more years. Now, in 1995, he can expect to live about 15½ years—three and a half years longer. Women have experienced even greater increases in their life expectancy. In recent years, the life expectancy of 65-year-olds has been going up a month a year. Relative to 20 years ago, 65-year-old men and women can expect to live about 20 months longer. That is a tremendous positive development for our society, but it's a bit of a problem if you're selling annuities to last a lifetime.

Sometimes when you're driving along, you see a sign that says sharp curve ahead. That's what we've got in terms of U.S. demography: sharp curve ahead.

The Social Security Administration believes—without terribly good reason, I think—that this rate of improvement will slow. If you extrapolate the month-a-year improvement trend, 80 or 100 years from now, 65-year-old women will have a remaining 25 or 26 years. The Social Security Administration projects continued improvement, but at a slower rate—maybe

FIGURE 4
The Increase in Life Expectancy at Age 65



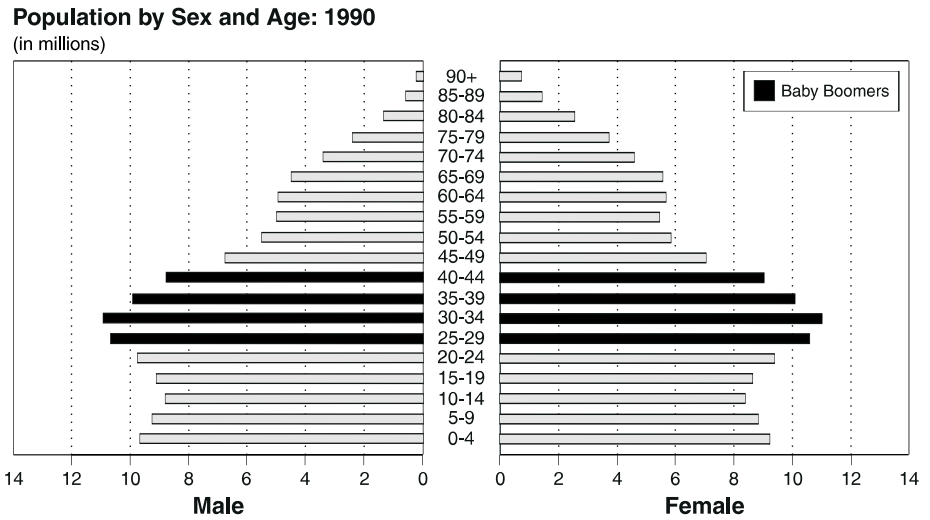
Source: 1994 Social Security Trustees Report

FIGURE 5
1955: Baby Boomers Start Elementary School



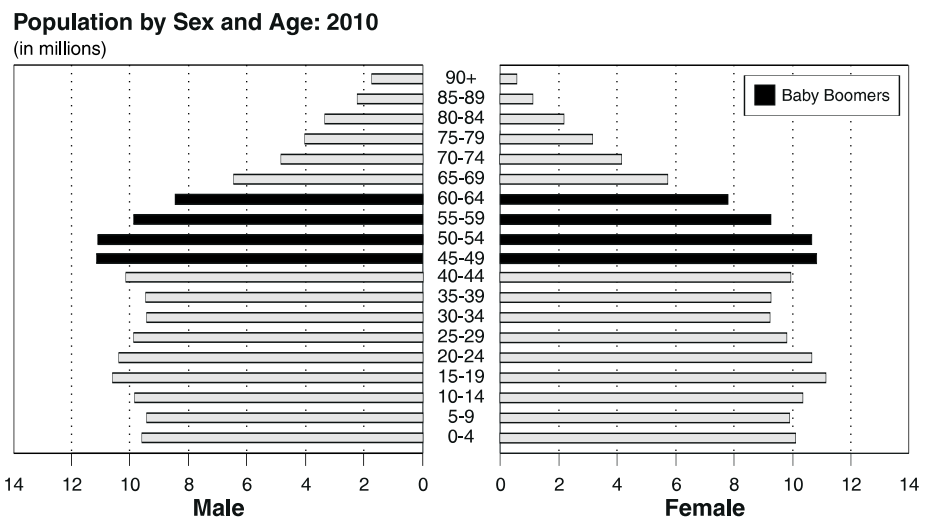
Source:
 U.S. Census Bureau

FIGURE 6
1990: Boomers Face Middle Age



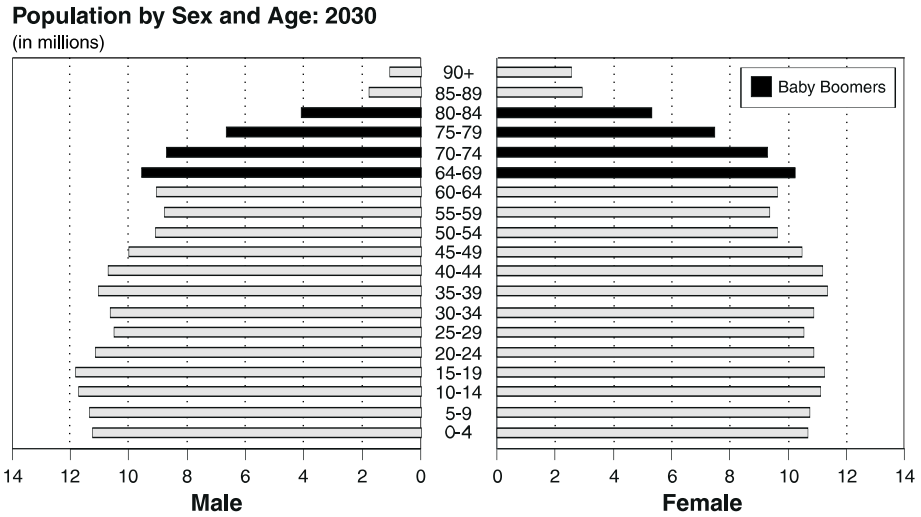
Source:
 U.S. Census Bureau

FIGURE 7
2010: Boomers on the Brink of Retirement



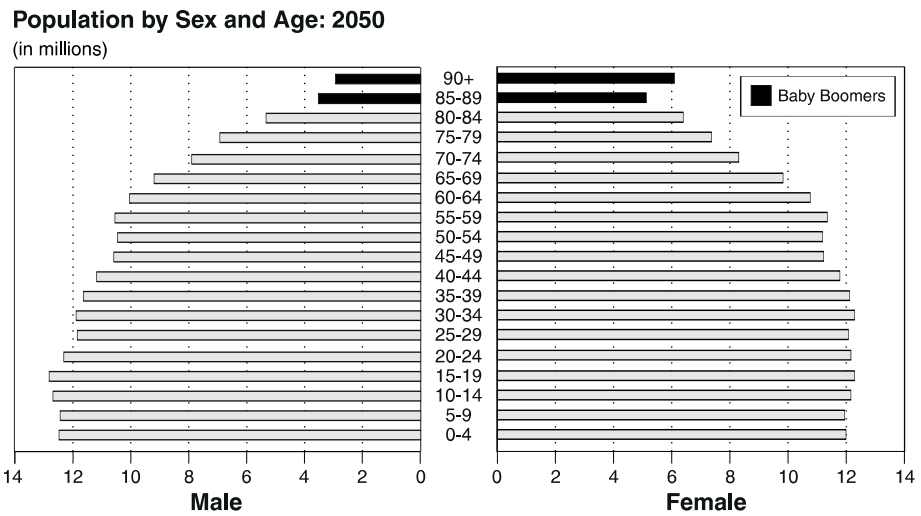
Source:
 U.S. Census Bureau

FIGURE 8
2030: Social Security Bankrupt and Youngest Boomers Turn 67



Source:
 U.S. Census Bureau

FIGURE 9
2050: Still More than 17 Million Boomers Alive

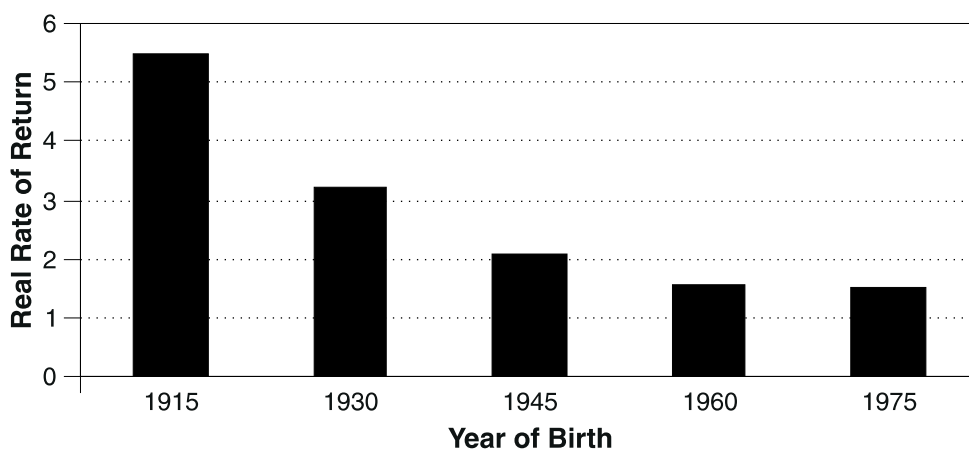


Source:
 U.S. Census Bureau

half a month per year. I don't think there is very good scientific evidence on the pace of future improvements in mortality.

Figures 5-9 illustrate the impact of the two demographic factors—cyclical birth rates and lengthening life expectancies—on the age structure of the population. These are the official intermediate projections of the U.S. Census Bureau. Notice, for example, that in both 1990 and in 2010, the boomers are the most numerous cohort alive. By 2030—the year that the Social Security Trust Fund is projected to be exhausted—we have tremendous numbers of people over the age of 85 due to improvements in mortality, and the youngest boomers are still just about as numerous as any other cohort. Even in 2050, the Social Security Administration predicts that 17 million boomers will still be around, and in the 90+

FIGURE 10
The Declining Real Rate of Return on Social Security Contributions
(for single earner couples)



Source: Boskin, Michael J., Laurence J. Kotlikoff, Douglas J. Puffert, and John B. Shoven, "Social Security: A Financial Appraisal Across and Within Generations," *National Tax Journal*, Vol. XL, No. 1, March 1987, pp. 19-34.

category, there will be six million women—about as many women as are now between the ages of 45 and 50.

What do these factors imply for the return on Social Security by generation? Depending on your age, your parents or grandparents did pretty well with Social Security, because they were around when the system was scaling up. They may have gotten a 5 or 6 percent rate of return on their Social Security contributions, in real inflation-adjusted terms. By comparison, today's single-earner couples can expect a 1.5 percent rate of return (see Figure 10). Single individuals will do considerably worse.

By 2030—the year that the Social Security Trust Fund is projected to be exhausted—we have tremendous numbers of people over the age of 85 due to improvements in mortality, and the youngest boomers are still just about as numerous as any other cohort.

IV. Lessons from Other Countries

Most countries have some form of Social Security system, and many of them have the same pay-as-you-go nature as ours. A few countries have made significant reforms, with probably the

most notable being Chile. Chile has completely privatized its system. Other Latin American economies—Colombia, Argentina, Peru—are copying what Chile did. Australia has reformed its Social Security system in an interesting way: they have instituted mandatory employer pensions, typically defined-contribution pensions. Sweden’s reforms look similar to some of the U.S. proposals. Sweden is suggesting that 2 percentage points be removed from their pay-as-you-go system for a new IRA-like system.

But there’s a big difference between our country and almost any other country in the world: the link between what you pay in and what you get out is much stronger almost everywhere else. So in other countries, the system looks more like deferred compensation and less like a tax-and-transfer arrangement.

A. Chile

Let’s take a look at Chile. First off, the Chileans had a much, much more favorable set of initial conditions for change than we do. We have 3.2 workers for every retiree; they had 9. They have an extremely young society, and as we’ve seen, it’s easier to change the retirement system when you don’t have many retired people or people nearing retirement. Their program was in even worse disarray than ours: they had multiple systems, hyperinflation, very high tax rates, and a very active underground economy to avoid those rates. As a result, there was fairly high agreement that the existing system was not working, and that made change easier. In addition, they had a large federal government surplus, so when they made the change, they were able to finance the liabilities of the existing system out of general revenues. The government paid for them. Obviously, we can’t do that here; we do not have a large federal government surplus. Finally, Chile had a strong dictatorship, which, as you all know, may have some disadvantages, but it certainly makes a radical change simpler to implement.

Depending on your age, your parents or grandparents did pretty well with Social Security, because they were around when the system was scaling up. They may have gotten a 5 or 6 percent rate of return on their Social Security contributions, in real inflation-adjusted terms. By comparison, today’s single-earner couples can expect a 1.5 percent rate of return. Single individuals will do considerably worse.

Chile's new system requires 10 percent contributions to what we would call individual retirement accounts. Workers also have to pay for a mandatory life insurance policy and mandatory disability insurance. So total contributions amount to about 13 percent of payroll. About 21 different vendors compete for this money—and they are heavily regulated. When they retire, workers can choose to get their money out over a fixed number of years or they can get inflation-indexed life annuities just like in the United States. One of the few advantages of the Chilean history of inflation is they actually have inflation-indexed financial markets and instruments and so the private sector can offer inflation-indexed life annuities.

Chile has received a lot of attention partly because the results have been so good: on average, these accounts have earned about 14 percent a year over and above inflation since 1982. If there are any structural flaws, that kind of performance will hide them, because everyone is so happy with the returns they've been earning. These funds have grown from an insignificant portion of the economy—1 percent of GDP—to around 43 percent of one year's output. In the context of the United States, 43 percent of GDP is on the order of \$3 trillion, so they are an important factor in the Chilean economy. These accounts now hold 55 percent of all government bonds, 60 percent of all corporate and mortgage bonds, and 11 percent of equities. Restrictions on investing in equities are now being eased; restrictions on investing in foreign assets are also being eased a bit.

Although there may be other factors at work here, the saving rate in the Chilean economy has improved dramatically. The gross saving rate had been 9.4 percent in 1982—a typical Latin American number; it is now about 25 percent of GDP—a typical Asian tiger number. Chile now has a very high savings rate, a very high growth rate, and the system has been extremely successful. That is why it is being copied. I would warn that a 13-14 year history is a very short timeframe if you're in the generational retirement business, so I think it's a little early to judge, but you can certainly say, so far so good.

B. Australia

Australia hasn't received nearly as much attention as Chile, although changes they've made are equally radical. Australia has an 80-year-old system called the age pension. The age pension has fairly modest benefits: 25 percent of average wage income for singles, 42 percent for couples. Benefits are financed out of general revenues; there is no payroll tax. The big problem there is that benefits are subject to both an earnings test and an asset test. That is, if you show up at retirement with too many assets, your Social Security benefits are taxed away. So naturally

people are careful not to show up with much wealth, because they don't want to lose their benefits. This tax begins for homeowners with fairly modest assets in U.S. terms—equivalent to \$120,000. Above that level, the more assets you have, the lower benefits you receive. That design flaw probably led to the low rate of saving in the Australian economy. And I'm not sure their reaction was the best one. Australia decided that, if people are not going to save voluntarily, then the answer is to mandate saving, and that's what they've done. Now employers must offer a pension system, with contribution rates at 5 percent for "small" employers and 6 percent for "large" employers. Those rates will rise to 9 percent by 2002.

There is not a lot of difference between Chile's system and Australia's. Chile requires a 10 percent employee contribution through payroll withholding, Australia requires a 9 percent employer contribution. Of course, it doesn't matter whether the employer or the employee is sending in the money; in both cases, the employee basically pays for the system. Australia has not earned the same tremendous rates of return as Chile—which may be why it has not received as much attention—but from an economic perspective, the two systems are extremely similar.

C. Sweden

Sweden has a system which isn't too different from ours. Sweden has a higher contribution rate, 18.5 percent, with a fairly loose connection between what goes in and what comes out. But one of the changes Sweden is making is to link payments with benefits much more closely. Contributions will look much more like deferred compensation and much less like taxes. In addition, Sweden will set aside 2 percent of the 18.5 percent for IRA-type funded accounts, a plan that's similar to some U.S. proposals. Sweden will also switch from the employers making all the contributions to a 50/50 split between employer and employee, like we have here. They know

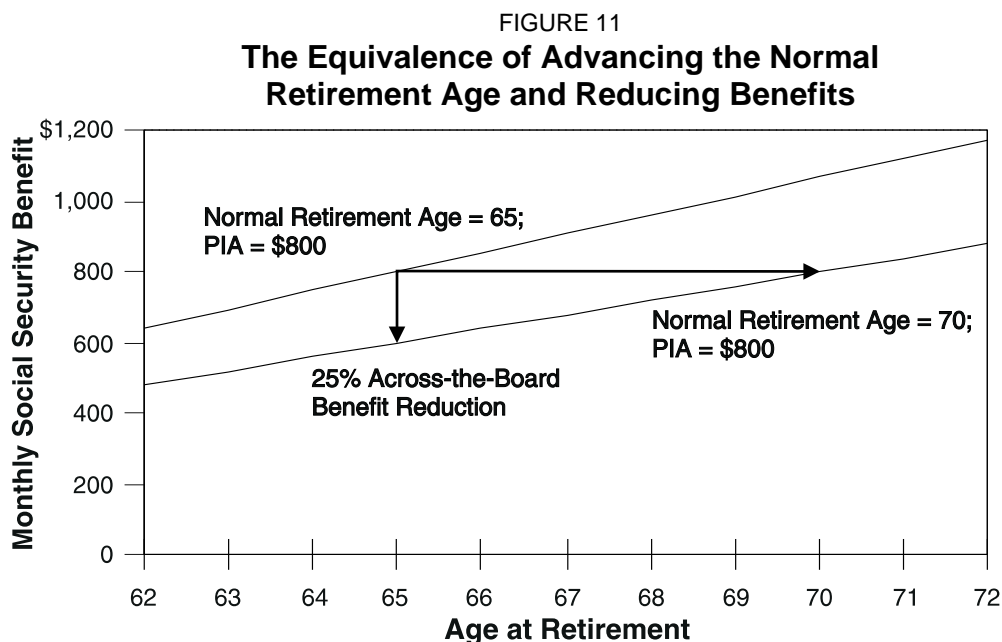
Before thinking about what we might do, let me say what we have to do. Basically, either contributions have to be raised by about a third, or benefits have to be lowered by about a third, if we are to live within the restrictions of our existing system. As presently structured, when the system goes broke in 2030, not only are there no assets in the trust fund, but current contributions fall short of current benefits by about 35 to 40 percent. We need big adjustments to get Social Security in balance.

this doesn't make any real difference, but they believe that, if the employees think they are making some of the contributions, they'll be more conscious of the costs of the system.

Sweden is also going to automatically reduce benefits as life expectancies improve, rather than raising the age of retirement. A particularly Swedish feature is that "child-care years" will count as if you worked during that period. Finally, you'll be able to retire at any age older than 60, with benefits actuarially adjusted to the retirement age chosen. So if you retire at 61, you get a lot less than if you retire at 81.

V. U.S. Alternatives

Now we're ready to look at the U.S. Before thinking about what we *might* do, let me say what we *have* to do. Basically, either contributions have to be raised by about a third, or benefits have to be lowered by about a third, if we are to live within the restrictions of our existing system. As presently structured, when the system goes broke in 2030, not only are there no assets in the trust fund, but current contributions fall short of current benefits by about 35 to 40 percent. We need *big* adjustments to get Social Security in balance. We could raise the contribution rate from roughly 12 percent to roughly 16 percent, but in this political environment, a big tax increase



Source: author's calculations

would probably be resisted, and for good economic reason. Another alternative would be to reduce benefits—and there are various ways to do this, although none of them are painless.

Taking our cue from some other countries, we could also consider more radical reforms, such as switching to a private system or a partially private system, as the Swedes are doing. If we do that, people could benefit from the much higher rate of return on private assets, but of course you can't forget about that \$11 trillion liability. Privatization is not a bad idea, given that life expectancies are improving, but because of that liability, this option is basically equivalent to lowering traditional Social Security benefits.

You could also raise the retirement age. Now, the normal retirement age is 65, the early retirement age is 62, but you can retire at any age you want over 62. If you retire later, you get more, if you retire earlier, you get less. Let's say we move the normal retirement age from 65 to 70 (see Figure 11). This change is almost exactly equivalent to a 25 percent reduction in benefits. Politically, it's probably better to characterize it as raising the retirement age, but it's equivalent to a benefit cut, no matter how you cut it.

The big problem for us, as I've hinted at already, is the transition: how do you move from a system with an \$11 trillion liability embedded in it for future generations to a system where we let future generations take care of themselves. Who is going to pay that \$11 trillion? The countries that have made the most radical changes—Chile and Australia—had much, much smaller transitional problems and much different political environments. So I don't think following in their footsteps will be particularly easy.

Let's consider one proposal already on the table: the Simpson/Kerrey bill in the Senate, called the Personal Investment Plan Act of 1995. This proposal has an element of privatization in it, yet lives within the current legislated contribution levels—that is, it does not raise contribution rates. So not only does it try to make the system financially viable by reducing benefits, but it reduces benefits even more to make room for a privatized portion.

Let's say we move the normal retirement age from 65 to 70. This change is almost exactly equivalent to a 25 percent reduction in benefits. Politically, it's probably better to characterize it as raising the retirement age, but it's equivalent to a benefit cut, no matter how you cut it.

I think it's economically sound, and it would work if people were willing to make the sacrifices. It sets aside 2 percent of the payroll tax, just like Sweden, to start up IRA-type accounts for everyone currently under the age of 55. Everyone older than 55 would stay in the existing system. Now in order to do this, benefits must be reduced. How?

We don't have time to look at all the mechanics in detail, but here are some key points. Remember that three-part formula with a 90, a 32, and a 15% part that determines the primary insurance amount? Under Simpson/Kerrey, those percentages would change to 90, 14, and 2 for those under age 26. In other words, only 2 percent of high wages would translate into a PIA and earn benefits. Those last two percentages in the PIA formula would also be reduced, although not as much, for other age groups between 26 and 45. The Simpson/Kerrey bill also raises the normal retirement age to 70 and the early retirement age to 65, lowering benefits in that way as well. And it lowers the inflation adjustment by half a percent, and limits its application. Finally, the spousal benefit is cut from 150 percent of the single person's benefit to 133 percent.

So you can see there are lots of benefit cuts that must be made to make room for that privatized 2 percent. But now workers are going to have that 2 percent saving account, which is going to grow. I know ICI has estimated that, if this system had been in place over the last 40 years, someone who earned the Social Security maximum and invested the 2 percent in the Standard and Poors 500 Index would be getting benefits 57 percent higher than today's benefits. So despite all these benefit cuts, you'd still be better off with that 2 percent personal account earning the S&P 500 return. Simpson/Kerrey also allows the trust fund to invest some of its money in common stocks in the hope of getting a higher return. Taken all together, this proposal would probably work if we could get political agreement.

ICI has estimated that, if this system had been in place over the last 40 years, someone who earned the Social Security maximum and invested the 2 percent in the Standard and Poors 500 Index would be getting benefits 57 percent higher than today's benefits. So despite all these benefit cuts, you'd still be better off with that 2 percent personal account earning the S&P 500 return.

The Social Security Advisory Council is considering an even larger privatized system, one that would set aside 5 percent of covered payroll for personal security accounts, basically IRA-type accounts. As you might guess, 5 percent is a huge flow of money, probably \$150 billion a year. This particular plan would establish a low, flat benefit that everybody would get, roughly \$360 a month for single people, adjusted for married couples. Over and above that, you'd get whatever your 5 percent account has accumulated. This plan would raise the normal retirement age to 68 and then index it for life expectancy improvements. There's a detailed transition plan, as with Simpson/Kerrey, and if you're over 55, you can ignore the new plan, since you stay in the old one. If you are younger than 55 and older than 30, you would get a blend of currently legislated benefits and the new plan, and if you're younger than 30, you would participate *only* in the new plan. That youngest age group would get a so-called recognition bond, a type of bond added to their accounts representing previous contributions to the old system.

The problem with this plan—maybe it's politically acceptable, maybe not—is that it requires some new taxes to cover the liabilities of the existing beneficiaries. They call this new tax the “liberty” tax: it will liberate us from the old pay-as-you-go system. One possibility would be a one percent national sales tax for about 70 years.

So let's recap the situation. We've got an important choice here. But it's the kind of choice that our political system seems to be the worst at making. We know Social Security is broken, but we also know that it can get by for another 25 or 30 years without fixing. Other countries are way ahead of us in addressing this problem. We'd be a lot better off if we fixed it today, but we don't *have* to. Of course, if we sweep it under the rug for another 25 or 30 years, all of the adjustments will be a lot worse. So we should do it now—fix it

We've got an important choice here. But it's the kind of choice that our political system seems to be the worst at making. We know Social Security is broken, but we also know that it can get by for another 25 or 30 years without fixing. Other countries are way ahead of us in addressing this problem. We'd be a lot better off if we fixed it today, but we don't have to. Of course, if we sweep it under the rug for another 25 or 30 years, all of the adjustments will be a lot worse. So we should do it now—fix it sooner rather than later.

sooner rather than later. Finally, we can fix it by simply raising the tax rates and lowering the benefits of the existing system or we can add an important element of real saving to Social Security, improving the system and the economy at the same time. My preference would be to make some fundamental changes in Social Security and to do so within the last few years of the twentieth century. Today's children and future generations will be better off if we tackle this problem now.



Institute viewpoints and research on a variety of issues may be obtained by ordering back issues of *Perspective*. Contact the Institute's Publishing Department at 202/326-5881.

Vol. 1, No. 1, July 1995: ***“Mutual Fund Shareholder Response to Market Disruptions”***

Vol. 1, No. 2, November 1995: ***“Improving Mutual Fund Risk Disclosure”***

Vol. 2, No. 1, January 1996: ***“Mutual Fund Regulation: Forging a New Federal and State Partnership”***

Vol. 2, No. 2, March 1996: ***“Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944-95”***



1401 H Street, NW
Suite 1200
Washington, DC 20005-2148