The Economics of Social Security Reform

Daniel McFadden[1]

I have watched with dismay the development of the current ideological dispute between conservative opponents of social insurance who are pushing Social Security personal retirement accounts as a step to dismantling the system, and defenders who categorically reject personal accounts as inconsistent with the current system's fundamental goals. The truth is that the Social Security system is not in immediate crisis, but it does need adjustments to guarantee its future solvency. It is possible to fix the system with marginal changes in tax and benefit formulas that leave its current structure intact. It is also possible to design social insurance reforms that will offer a degree of individual choice, encourage savings, and reduce political and demographic risks to the system without destroying its important "social safety net" features of insurance and redistribution that protect the most unfortunate among us. However, "reform" can also be used to "embrace, corrupt, and destroy" the system under the guise of saving it. It will be truly unfortunate if the penchant for aggressive marketing and zeal for market solutions in the Bush administration result in what one might dub "the Fox News plan to guard the Social Security chickens".

Is the Social Security "crisis" manufactured? The system has long-term, but not immediate, problems. The Social Security Trust Fund, which by law is held in U.S. Treasury bonds, currently has a positive balance and is growing. However, if payroll tax rates, retirement age, and benefit formulas remain unchanged, then after about 2018 when the big bulge of baby boomers begin to retire, benefit payments will exceed payroll tax receipts. After about 2024, this gap will exceed Trust Fund interest income, and the Trust Fund will begin to shrink. Some conservative pundits have argued that the assets of the Trust Fund are illusory, since the government could refuse to redeem its Treasury bonds, so that 2018 will be a year of reckoning. This argument is specious. U.S. Treasury bonds are viewed in the U.S. and around the world as the "default-free" standard for financial assets, and it is difficult to imagine our government defaulting voluntarily, destroying the U.S. and world financial systems and triggering a worldwide depression. What is true is that the government will find it increasingly difficult to run deficits, putting upward pressure on interest rates, as foreign governments like China and Japan become more reluctant to buy Treasury bonds and the Social Security trust fund becomes a net seller rather than a net buyer. However, Social Security is not the cause of this problem. Rather, this is a problem of politicians obfuscating the connection between the level of government services the public expects and the level of taxation needed to pay for these services. If the Bush administration were honest about its agenda, then it would substitute "service" for "tax", and its slogans would be "No New Government Services!" and "Permanent Service Cuts!". If a majority of voters support this agenda, then at least they are confronting the real public policy choice they face.

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[1]Daniel McFadden is the E. Morris Cox Professor of Economics at the University of California, Berkeley, and an associate of the National Bureau of Economic Research. In 2000, he received the Nobel Prize in economics. He is currently president of the American Economics Association. Since 1984, he has investigated the economic status of the elderly under grants from the National Institute on Aging.

The combined effect of retiring baby boomers and increased life expectancy will eventually lead the Social Security system to exhaust its trust fund, most likely between 2042 and 2054. Thereafter, the system could continue to pay about 70 percent of scheduled benefits from current payroll taxes, but would have to either cut the remaining benefits or rely on general government revenue to make up the difference. In percentage terms, continuation of full benefits after the trust fund is exhausted would require a transfer of about 2 percent of GDP, a little less than the current U.S. government deficit, from general government revenues to the social security system. This is a burden the economy could almost certainly handle, but it is not problem-free, economically or politically The date of exhaustion of the trust fund and the additional funding required after that are quite uncertain, and will be postponed if over the next few decades, fertility rates, immigration rates, or employment rates are higher than anticipated, increases in life expectancy are less than anticipated, or people work longer than anticipated. On the other hand, if things go the other way, or government fails to handle problems well, social security could exhaust its trust fund a decade sooner. While the Bush administration is overselling the social security "crisis", it is true is that the longer we wait to deal with social security's problems, the harder it will be to fix the system. Thus, "crisis" or not, a serious effort now to repair this system should be welcome.

It is not necessary to move the U.S. social security system toward a defined contribution pension program secured by private sector assets, or to go further and divert some or all of the defined contribution part into individual, privately-managed accounts, to put the system on a sound fiscal foundation. Fiscal solvency can be achieved via some combination of adjustments such as modest increases in the payroll tax rate, tilting the benefits payout formulas to encourage later retirement, indexing benefits to life expectancy in the same manner as a private annuity, and raising the upper limit on wages subject to payroll taxes. A well thought out plan to accomplish this has been laid out by Peter Diamond and Peter Orszag in *Saving Social Security: A Balanced Approach*, Brookings, 2004.

On the other hand, moving Social Security toward a funded system in which contributions are used to accumulate private assets and benefits are paid in part from the earnings of these assets, tying social security pensions more closely to an individual's contributions, and tying returns on contributions more closely to the performance of the economy, and making the transition to this system without a debt-shuffle "shell game", would be an economically sound method of protecting the program from demographic swings. Carefully and conscientiously designed personal accounts in a funded pension program could give individuals more flexibility in their financial planning, and in the long run raise national savings rates. However, even though a well-structured privatization plan could be a good thing for the social security system in the very long run, over the next several decades it would be more painful to implement than some of the simpler fixes for the system. The reason for this is the transition problem. If some of current payroll taxes are diverted from the trust fund, then the trust fund will be depleted more quickly and subsidies from general government revenues to pay mandated benefits will have to come earlier and be larger than the unreformed system would require. To handle this, the government will have to cut other services, a politically unpopular move, or run a deficit, which will undo the positive effect on national saving that personal accounts might have. For personal accounts to be beneficial, they need to be funded through real belt-tightening, for example an increase from 6.2 to 8.2 percent in the worker's part of the payroll tax, with the difference earmarked for the worker's personal retirement account.

Social security currently has two key features: First, from the standpoint of the individual worker, social security is a forced savings plan coupled with a defined benefit pension. The government requires you to pay payroll taxes, currently 12.4 percent of wages, split between employee and employer, and promises to pay you social security benefits beginning at a specified retirement age. These benefits are tied by a formula to your lifetime wages, but the level of benefits you receive does not depend on the performance of the stock market, or except for price indexing to keep purchasing power roughly constant, on the performance of the economy. A pension plan is called "funded" if your contributions are held as assets, like stocks, and accumulated until you retire, and "pay-as-you-go" if your contributions are paid out immediately as benefits to current retirees, with your pension scheduled to be paid from the contributions of the next generation. Our social security system is a mix that is largely "pay-as-you-go", as the trust fund balance is sufficient to cover only about 15 to 20 percent of the benefits due to past contributors to the system, with the rest slated to come from future contributors. This puts your benefits in the current system at some demographic and political risk, as they depend on the willingness of voters and politicians to maintain the system despite demographic fluctuations in the ratio of workers to retirees. The issue of funding is important because the primary argument for personal accounts is that they will lead toward a funded system, promoting savings and reducing risk from fluctuations in fertility and immigration rates.

Second, social security has an important insurance and redistribution component. It provides survivor benefits to spouses and minors, and to workers who become disabled. It also ensures that you cannot outlive your resources; the benefits will still be there even if you are lucky enough to live to be 100. The United States has a very limited social safety net for the truly unfortunate, without comprehensive programs for housing, medical care, or food for the needy, so that the insurance provided by Social Security and its companion Medicare program play a critical role in keeping unlucky elderly out of poverty and off the streets. The social security *replacement rate*, the ratio of social security monthly income to monthly income when working, is substantially higher for people who were minimum wage workers than it is for people who were high-wage workers, particularly when one factors in the somewhat higher probabilities that poor people will become disabled. Conservatives argue that redistribution in social security is overstated, because on average wealthy whites live longer than poor blacks, and thus receive more social security benefits. The argument is misleading because even after this effect and similar factors are taken into account, the ratio of lifetime social security benefits to lifetime payroll tax payments remains higher for the poor than for the rich. Conservatives also argue that Social Security leaves more than ten percent of the elderly below the poverty line. This is true, but it is also true that poverty rates among the elderly are lower than poverty rates in other age categories, and this result is substantially due to redistribution within the current Social Security system. A major concern about personal accounts is that they will lose the "social safety net" features of the current system. Widows currently have the highest poverty rates among the elderly, and it is this group that will be most negatively impacted in the future by fraying of the "social safety net".

How would personal accounts within Social Security work? Their key feature is that the benefits you eventually receive are tied directly to the contributions you make, with returns that may depend on the performance of the stock market and on investment decisions you make. Such "defined contribution" pension plans are increasingly popular with businesses and governments around the world, primarily because they shift risk from themselves onto the individual. This is good for the individual only if the improvement in expected return is sufficient to compensate for the additional risk. Historically, the stock market has outperformed Treasury bonds, although some of this is compensation for the added risk. The proponents of personal accounts assume that stocks will continue to outperform bonds for the next 75 years, allowing the government to gradually reduce the replacement rate of the more traditional defined benefit component of social security without reducing the overall replacement rate. This may happen, but it is not guaranteed.

Because your benefits from a private account are determined solely by your own contributions, there is no cushion if you become disabled, or die early and leave a spouse or children with limited resources. Thus, a move toward personal accounts is a move away from the insurance and redistribution features of a "social safety net". Conservatives argue that private markets will offer these insurance services to those who want them. If insurance markets offer complete coverage at actuarially fair prices, it would be true that with a combination of privately purchased life insurance, disability insurance, and annuities, each individual could provide his or her own "safety net". However, private insurance markets are notorious for not working well. For example, a key element in a private market parallel to the current social security system would be inflation-indexed annuities, but these are not available from the market at prices that are actuarially fair. Buyers and sellers in insurance markets have different amounts of information, and this leads to two phenomena, "adverse selection" and "moral hazard", that disrupt the efficient operation of these markets. What adverse selection means is that purchasers of an insurance contract will be those most likely to make insurance claims. For example, annuities will be purchased by those who expect to live the longest. Moral hazard means that individuals can game the system. For example, an individual given the right to invest his social security contributions in a private account will have some incentive to pursue risky investments, on the grounds that if he wins, he is on easy street, and if he loses, the government (or God) will somehow provide. To take an extreme illustration, an individual might choose to invest all his contributions in "Megabucks" lottery tickets. Most people would agree this is foolish, but stock market portfolios can also be risky. The question is how the government should set and enforce limits on the risks individuals can take, and how it can insure at least subsistence benefits without giving individuals an incentive to "gamble with the government's money". The best way to limit adverse selection and moral hazard is to offer social security contributors a relatively narrow range of investment options that build in insurance against very bad outcomes.

One of the favorite conservative arguments for personal accounts is that by expanding the choices of individuals and forcing them to live with the consequences, we give people the right incentives to save and take responsibility for their own futures. Unfortunately, some people are going to make bad choices or have bad luck. A significant difference between the U.S. and a number of other developed countries where personal accounts have been adopted in some form is that these countries have an adequate “social safety net” independent of their social security system, and thus it was relatively easy for them to take advantage of the benefits that personal accounts offer without ripping up the social safety net. Given the aversion in the U.S. to any government program that smacks of “welfare entitlements”, this does not appear to be a practical option here. Some ardent conservatives may embrace a Dickensonian world in which the unsuccessful elderly are left to “freeze in the dark”, but many will reject this vision, if for no other reason than to keep octogenarian beggars from their door and indigent parents out of their guest bedroom. The most critical feature that any sensible Social Security reform should have is that individuals be guaranteed replacement rates that prevent the rate of poverty among the elderly from rising.

The biggest political question about privatized personal accounts is how to prevent a privatized system from being plundered with excessive management fees and gutted of its “social safety net” features, and how to protect individuals from investments that are oversold or too risky. It is easy to botch privatization programs, particularly when strong corporate and political interests constrain the economic market design. Cases in point are the savings and loan disaster of the 1980's, British privatization of rail lines, and privatization of California energy markets. People should have learned by now that putting your life's savings in the hands of your employer's pension fund manager, your insurance company, or your stock broker is not necessarily safe, and that these stewards do not always meet their obligation to put your interests first. In fact, there are crooks out there, and it is not always easy to tell them apart from legitimate and judicious financial operators. Keeping the financial managers of privatized social security accounts honest, and insuring individuals without creating additional moral hazard problems in the operations of these financial managers, are major issues in the design of successful privatized social security accounts.

There are two major ways of setting up personal accounts. First, they might be “provident accounts” in which your contributions stay in the Social Security Trust Fund, invested in a combination of mutual funds you select, with the Social Security trustees setting the requirements for mutual funds to qualify as options, and using competitive bidding to keep a lid on private management fees. This would be similar to how many company-financed defined contribution pension plans, and the successful Thrift Security Plan for government employees, are managed today. Second, personal accounts might be an expansion of current conventional or Roth IRA’s, where the individual picks his or her own fund manager and makes portfolio decisions subject only to rules on the kinds of investments allowed and when funds can be withdrawn.

There are experiences in other countries with each of these forms. Sweden has the equivalent of “provident accounts”. Chile and Great Britain have privately-managed personal accounts (for some or all of their contributions) that resemble IRA’s. These forms differ substantially in their administrative costs, and how easy individuals find them to use. Swedes have found their system somewhat confusing, and a large majority of new enrollees take the default option, but its management costs are reasonably low. The British system has been unsuccessful, and is a lesson in how not to design a system of personal accounts. There, the management fees on the accounts averaged 125 basis points, eating up about 25 percent of what the accounts earned. Much of these fees were spent in advertising the funds, and overselling them has generated a storm of lawsuits. Chile has had a good experience with privatized accounts, primarily because the transition to them was made using a government surplus, increasing national savings, the expansion of stock ownership led to sensible reforms in financial markets, and the country experienced high growth rates that fueled strong growth in the value of stocks. Even so, their privatized system is incomplete in its coverage, missing many of the poorest members of their society, and its management costs expressed as a proportion of contributions are substantially higher that than our current social security system's ratio of administrative costs to contributions. The Bush administration seems likely to propose personal accounts in the Chilean model. This form, not incidently, promises large profits for Wall Street. However, the inefficiencies associated with handling small accounts will eat up much of the profits to managers and gains to holders that personal accounts promise, particularly for low-wage workers. The only effective way to control these management fees is to aggregate individual personal accounts. This could be accomplished, for example, by originating personal accounts as "provident accounts" with limited investment options, and allowing individuals to opt-out and "roll over" their accounts into privately managed IRA's only when they have accumulated sufficient balances and credits so that they are guaranteed at least a subsistence pension.

Social security needs changes in order to remain fiscally sound. This could be accomplished without radical reform, as proposed by Diamond and Orszag. Further, a combination of the changes they propose and carefully crafted system of personal accounts, financed through new savings rather than diversion of current payroll taxes and originated as "provident accounts" in order to control management fees and limit risk, would preserve the social safety net, benefit the stability of the system by making it less vulnerable to demographic and political risk, improve consumer welfare by raising pensions above the subsistence floor the current defined benefit system provides, and increase national savings and economic growth. On the other hand, hasty changes driven by financial and insurance industry lobbyists, guided by opponents of the concept of social security, sold by deceptive marketing, and financed by government debt, could be disastrous. Does the current Congress have the distance from industry lobbyists and political constituencies to design a successful social security privatization plan? If the poorly designed prescription drug benefits package recently added to Medicare is any indication, the answer is absolutely not. Social Security is too vital a program in this country for reform to be left to the politicians, turned into a partisan issue, and used as an ideological football.