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The Proposals of the Advisory Council on Social Security: Not Only Undesirable but Also Impossible of Enactment

by Robert J. Myers

As of September 1, 1996, the report of the statutory quadrennial Advisory Council on Social Security (AC) had not yet been released. However, for several months, its general contents had been made known to the public, and the media had widely reported thereon. (It may be noted that the law prescribed a deadline of January 1, 1995, for this report; part of the reason for failing to meet it was the long delay in the appointment of the AC by the Secretary of Health and Human Services.)

Unlike previous ACs, which generally involved unanimous or consensus recommendations, this AC broke down into three separate groups, each with their own quite different proposals. There were a few minor matters, however, on which all 13 members agreed. All three plans involve some degree of so-called privatization—the investment of assets, either for individuals or the program as a whole, in common stocks or other forms of private investments.

In recent years, there has been widespread proclamation that the Social Security program (Old-Age, Survivors, and Disability Insurance, or OASDI) is in a state of crisis. This view is certainly more of an "impression" than a "fact." *Webster's Collegiate Dictionary* (5th ed.) defines "crisis" as "A crucial time; specifically the culminating point of a period of business prosperity, following which a period of liquidation ensues" or as "The decisive moment; turning point."

In actual fact, no immediate or short-range financial problem is at all likely to face the OASDI program, so the use of the word "crisis" is unfounded, unless it is qualified by "possible" and "in the far-distant future." Under the official intermediate-cost estimate in the 1996 OASDI Trustees Report, the real point of crisis—when the trust-fund assets become exhausted—is 2029, while even under the high-cost estimate it is 2016, or two decades hence. Further, under the low-cost estimate, no crisis occurs during the 75-year valuation period (or later as well).

The assumptions underlying the low-cost estimate are reasonable and have been developed in a professional, unbiased manner by the actuaries at the Social Security Administration. These assumptions are not highly likely, but they are possible. Among the circumstances that could make this happen are the following: (1) increased national productivity, resulting in higher real-wage growth; (2) further increases in fertility rates (which, despite widespread public belief to the contrary, have been increasing during the last 20 years); (3) significant net immigration of young persons (which, in essence, has similar effect as increased fertility); and (4) a proper tightening-up of the disability-benefit provisions, so that persons who are really not disabled do not get on the rolls and those on the rolls who recover and can be employable are removed.

Nonetheless, it seems likely that a long-range financing problem exists. Accordingly, it is only prudent to take corrective action soon—but of a gradual, deferred nature, not one that is abrupt and radical. Among other things, such action should help to restore public confidence in the OASDI program. And, if the actual future experience turns out more favorably than now estimated in the intermediate-cost estimate, changes of a liberalizing nature (for example, lowering, or preventing any scheduled increase in, the contribution rate or the full-benefits retirement age) can easily be done.

This paper will first discuss the underlying nature of the OASDI program and its current financial status and will then discuss certain widespread, but erroneous, views of certain aspects of the program. Then various proposed solutions of the long-range financing problems will be described and critiqued with special emphasis on the several AC alternatives, along with my preferred solution. It is important to note that there is one "dirty little secret" about the AC proposals—actually, a gigantic one—that is rarely mentioned: namely, that all of them are impossible of enactment, for general-budget reasons (as will be brought out later).

The Nature of the OASDI Program

OASDI is a social insurance program that has many more similarities to group benefit plans established by private employers than to individual insurance and savings plans. In the latter, individual equity must reign supreme. In employer group plans and social insurance, there is usually—and desirably—a mixture of individual equity and social adequacy. It is for this reason that I believe that OASDI should provide only a reasonable, universal floor of economic security protection and that the vast majority of people should build on top of it through employer pensions, private savings, and home ownership.

Current Financial Status of OASDI

In mid-1996 the assets of the OASDI trust funds amounted to about $545 billion. This was more than $100 billion in excess of what they were then estimated to be at that time when the 1983 amendments were enacted. The excess of income over outgo in 1996 will probably be about $70 billion. This annual excess is estimated (according to the intermediate-cost estimate) to increase to about $140 billion in 2010 and then decrease slowly until 2019, when income and outgo will be approximately equal and the fund balance will be about $2.9 trillion. Thereafter, outgo is estimated to exceed income, and the fund balance decreases until being exhausted in 2029.

Another measure of long-range actuarial status is the "actuarial balance." If this is zero, it means that, according to the particular estimate, income will exactly meet outgo over the 75-year valuation period, and the final balance at the end of the period will equal the next year's outgo. A negative actual balance, expressed as a percentage of taxable payroll, is the required level increase in the combined employer-employee contribution rate that is needed to bring the program into actuarial balance. According to the intermediate-cost estimate in the 1996 OASDI Trustees Report, the negative actuarial balance is 2.19% (or about a 1.1% increase in the tax rate for both employers and employees—hardly an "unbearable fiscal burden").

Have the Trust Funds' Monies Been Stolen?

Many people assert that the current approximately $550 billion of investments in the OASDI trust funds are not really there for the benefit of future beneficiaries, because they have been "stolen" and "spent for other government activities." The latter is true, just as it is for newly issued government bonds that are bought by the general public—or, for that matter, by the bonds sold by corporations or the deposits in savings banks (which are "spent" by being loaned to other persons). So, the monies have been spent, but not stolen. And, if the trust funds had not had the monies to loan to the Treasury, the latter would have had to have borrowed them from the general public.

Are the Trust-Fund Investments "Worthless IOUs"?

Certainly, like any other bonds, those held by the trust funds are IOUs. But they are no more "worthless" than similar securities held by the general public, and they are part of the recorded national debt.

Some people allege that they are worthless because they are not marketable (although the trust funds can hold marketable issues—and have done so, to a small extent, years ago—they do not do so now because the large monthly redemptions to pay benefits would disrupt the government bond market). However, the trust-fund bonds are redeemable at par (plus accrued interest) on demand, and this occurs every month. This feature can be advantageous at times (when the bond market is low)—and vice versa. The special-issue securities held by the trust funds bear an equitable long-term interest rate (for current issues, about 7.0%).

The fact that the trust funds' securities are not marketable is not really relevant, because many public issues (such as the Series E ones) are similarly not marketable, although redeemable on demand.

The Ever-Decreasing Ratio of Workers to Beneficiaries Is Unsupportable

Some critics point out that the ratio of workers contributing to the OASDI program to the number of beneficiaries (not only old-age and disability retirees, but also their spouses, children, and survivors) has been decreasing steadily over the years and is estimated to continue to do so in the future. They then conclude that OASDI is really a Ponzi scheme and is unsupportable over the long run.

In fact, such a ratio of workers to beneficiaries was about 360 to 1 at the end of 1940 (and infinity to 1 at the end of 1939), 42 to 1 in mid-1945, 16 to 1 in 1950, 5.1 to 1 in 1960, 3.7 to 1 in 1970, 3.2 to 1 in 1980, and 3.3 to 1 in 1995. According to the intermediate-cost estimate, it will fall to 3.1 to 1 in 2010 and then to 2.0 in 2030 and thereafter (actually, decreasing slowly to 1.8 to 1 in 2070). But this trend, in general, is no great surprise. It was always known that, as in any pension plan that gives credit (directly or indirectly) for service before the inception of the plan, such a trend would occur over time. Moreover, in the future, such a trend would be leveled off at a higher ratio if the unreduced-benefits retirement age is increased (that is, the definition of "retirement age" is dynamic in the face of increasing longevity).

Relevance of the Money's Worth Concept

Currently, many younger persons, especially higher-paid ones, are concerned that they do not get their money's worth from their OASDI contributions (especially when their employer's share is considered). In other words, they believe that they could do much better by investing the money themselves. This is almost certainly the case, especially if the employer contribution is considered to be individually allocable to each employee. But this is not done in most private benefit plans, where each employee does *not* get benefits exactly equal to the *average* employer contribution rate (for example, defined-benefit pension plans or maternity-benefit plans for only the female workers). The same is even more true with school taxes as between those who have children, those who will have no more children, and those who never have children.

In the same way, the OASDI program involves a broad sharing of the economic risks among the low-paid and the high-paid, among those with eligible dependents, and among those who were near retirement age when the program began and those in it for their entire working lifetimes.

Further, it should be kept in mind that those near retirement age when they were first covered, who thus received large "actuarial bargains" when the program is considered "in a vacuum," often supported their own aged parents, directly or indirectly, from their own pocketbooks. Because of OASDI, this situation will be much less frequently the case now or in the future.

Recommendations of the Advisory Council

The three sets of AC proposals differ basically as to how much of a change would be made in the present OASDI program. These sets will be designated as "traditional," "intermediate," and "extensive." There was, however, agreement on a few matters, such as compulsory coverage of all newly hired state and local government employees and income taxation of benefits in the same manner as private pensions (the present procedure being an approximation thereto, but being on the low side for some beneficiaries). The AC also expressed support for automatic cost-of-living adjustments for benefits and for early action to eliminate the estimated long-range actuarial deficit under the intermediate estimate. Further, the AC expressed disapproval of means testing that would condition benefit receipt on whether substantial other retirement income is received.

All three sets of proposals involve, to a greater or lesser extent, investment in the private-securities markets of some of the monies that would otherwise go into the trust funds, probably substantially in equities. Such a procedure has the drawbacks of investment risk and higher administrative expenses. More importantly, from a practical, political standpoint, it makes the proposals impossible of enactment, because all of them would result in significant increases ($25–150 billion per year, depending upon the specific proposal) in the general-budget deficit, whereas all parties are strongly intent on decreasing the deficit, not increasing it. Further, there is the question as to who will buy the government securities that the trust funds would otherwise have bought, and then what will be the effect on interest rates and general investment markets.

The "traditional" set of proposals includes (1) increasing the number of computation years for retirement benefits from 35 to 38 years, (2) increasing the contribution rate by 0.8% for both the employer and employee, beginning in 2045, and (3) investing a portion of the trust-fund assets in a passive equity index fund, beginning in 2000 at $25 billion until a maximum of 40% was so invested. The increase in the computation years is undesirable, because it adversely affects women workers, who often do not have continuous participation in the paid labor market. The investment in equities involves the risk of adverse market fluctuation, and the possibility that "opening the door" in this way will lead to future changes such that indexing will not be followed. Concerns are that politics will enter into the process, and even that "socialism by the back-door method" will result with such massive sums ultimately being available.

The "intermediate" set of proposals includes, in the benefit area, (1) reducing benefits for high-earning persons, (2) reducing spousal benefits, but increasing survivor benefits for two-earner couples, and (3) increasing the "full-benefits" retirement age as under present law to age 66 for those who attain such age in 2009, then continuing to increase it to age 67 for those who attain such age in 2016, and thereafter indexing it to increases in longevity. The reduction in benefits for high earners will make the discontent as to money's worth even greater. The other two changes have their good features, especially that as to the retirement age.

The key feature of the "intermediate" set is the establishment of individual accounts within the OASDI program, perhaps with separate trust funds from the existing two funds, to be funded with an additional employee contribution rate of 1.6%. Individuals could choose between a limited number of types of indexed funds (modeled after the existing thrift plan for federal employees). Upon retirement, the accumulation would be converted to indexed annuities, although this is much easier said than done, as is also the matter of what happens in cases of death before retirement. There is also the problem that for many millions of persons the 1.6% contribution rate will produce only small amounts, received sporadically, and the administrative expenses will consume much of the contributions, especially considering that the investment records must be continuously updated and the developing experience passed on to the participants regularly. Conversely, under OASDI as it now is, small amounts of earnings are merely left unchanged in the records over the years.

The "extensive" set of proposals includes, in the benefits area, (1) the same changes, in general, in spousal benefits and the "full-benefits" retirement age as in the "intermediate" set although, as to "full-benefits" retirement age, achieved in a slightly different way, (2) increasing the "early" retirement age to 65, and (3) drastically altering, but in a phased-in manner for those now under age 55 until fully so for those now age 25 or under, the benefit-amount structure. The altered benefit structure, in the ultimate condition, would be a basic flat primary amount that would be about $410 per month in 1995 dollars and would rise in the future in accordance with changes in earnings levels.

The key feature of the "extensive" set is the establishment of individual accounts within the private sector, such as with mutual funds, to be financed by reducing the employee OASDI contribution rate by 5.0% and requiring such amounts to go into individual accounts. To finance the transition and maintain current benefits for those now aged 55 and over, a so-called "temporary" increase in the employer-employee tax rate of 1.52% would be imposed for the next 70 years, and there would also be "temporary" borrowing from the general Treasury, to be gradually repaid in future years.

Individuals could withdraw amounts from their individual accounts beginning at age 62, but by no more than would reduce their investment income therefrom to below the poverty level (again, easier said than done in actual practice with varying investment returns).

From a benefit standpoint, several problems arise under the "extensive" plan. First, no coordination in benefit level exists as between young-survivor and disability benefits and retirement benefits. Second, it is likely that low-earning individuals would receive smaller benefits than under present law. Third, the many choices available and the significantly different benefit results would be very confusing to many participants.

From the standpoint of whether the "extensive" plan could be politically enactable, there are what would seem to be overwhelming difficulties. First and foremost, the general-budget deficit would be enormously increased, by as much as $150 billion per year starting immediately. Second, both employer and employee total taxes (including, for employees, the amounts going to the individual accounts) would be increased, although the employees might not be too concerned, because the OASDI tax alone would be lower, and what goes to the individual accounts is "theirs." Third, the national debt would be increased (unlike under the other two sets of AC proposals).

My Recommendations

The traditional approach of solving financing problems for the OASDI program, which has been successfully used in the past, would both slightly reduce benefit outgo and increase contribution income—both in a deferred, gradual manner.

The major changes would be to increase the "full-benefit" retirement age (now 65) beginning in 2003 just as in present law (at the same annual rate of increase), but extend it to age 70 in 2037 (instead of age 67 in 2027), and to increase the employer and employee contribution rate by 1/4% each in 2015 and then again in 2020, 2025, and 2030 (a total rise of 1% each). Considering the almost certain increase in real wages in the future, such tax-rate increases would be scarcely noticeable, and certainly easily affordable. In addition, all newly hired state and local government employees who would not be covered under present law (about 25%) should be compulsorily covered, as was done for federal workers in the 1983 Act, and all benefits should be made subject to federal income tax—although not necessarily taxed—in exactly the same manner as is now done for private pensions.

The foregoing changes would restore the long-range actuarial balance of the program under the intermediate estimate. They would also result in a more favorable fiscal picture for years following the valuation period.

In addition, a compulsory individual-accounts program should be legislated on top of the revised, strengthened OASDI program. The contribution rate therefor, payable solely by the employee, should be 2% of covered earnings but with provision for noncoverage—that is, return of contributions—for low earners, because the administrative expenses for the individual accounts in such cases would consume too much of the contributions to make this procedure worthwhile.

Discussion by Krzysztof M. Ostaszewski

Motto:
"The First Law of Economists: For every economist, there exists an equal and opposite economist," World Wide Web site Jokes about Economists.

There Is a Crisis!

The report of the statutory quadrennial Advisory Council on Social Security (AC) has been awaited for a very long time, and at this point we still have only substantial leaks about its content, but no official substance. Many political decision makers now admit financing problems in both the Social Security and Medicare systems, although it is often stated, notably by the Honorable Tom Daschle with respect to Medicare, that financing problems did exist before, and that small changes, gradual reforms, were always sufficient to put social insurance in balance, and they will be just as good now.

Mr. Myers begins his analysis by pointing out that the current AC's recommendations differ dramatically from the historical norm. First, there is no consensus as to the desired course of action. Second, the proposals suggest significant structural changes in the Social Security system. Mr. Myers continues to analyze those proposals and finds them all undesirable, for quite significant reasons. I believe that Mr. Myers's work constitutes a significant contribution to the current debate and indeed should be required reading for the AC.

However, I find myself in a very significant disagreement with Mr. Myers's central premise, that there is no cause for alarm. If there is no crisis, why did it take so long to produce the report? Why are we having such large problems during a period of economic growth? Indeed, social insurance systems in the United States have reached a long-term actuarial deficit of at least twice the size of both the national debt and the structural budget deficits.

I believe many answers could be found in better understanding of social insurance. It is often suggested that social insurance is unrelated to the national economy, or fiscal policies, or government debt. In fact, social insurance is economically analogous to a government debt-rollover strategy.

Kotlikoff (1992) points out that social security is equivalent to the following:

- Initial beneficiaries generation receiving welfare transfer payments
- Government issuing bonds in return for payroll tax contributions
- Benefits termed "contributions plus interest"
- Special tax/transfer payment instituted for beneficiaries in order to achieve the prescribed benefit levels.

One can easily observe that the accrued liabilities of a pay-as-you-go (PAYGO) system are economically equivalent to issued marketable government bonds. Either one is basically a forward commitment to collect taxes.

Note that inclusion of benefit accrual in government accounting of debt would have significant accounting consequences. The budget deficit figure actually would have been increased by the excess of the social insurance benefit accrual over the benefit release to produce a result consistent with the way all government expenditures are counted. Note that no other position in the government accounting system except for social insurance nets future yet uncollected taxes against future yet unpaid benefits. If viewed as other government activities, all social insurance tax receipts would be counted as new bond issuance, and all benefit payments as principal and interest payments on national debt.

The national debt has been sufficiently studied by economists to point out several of its consequences:

- Debt-generated government expenditures distort prices; in the case of social insurance, they result in the tremendous increase in consumption by the elderly, and some increase in consumption by the poor
- Government debt crowds out private capital
- There is a possibility of a "hard landing" if investors abruptly stop purchasing government bonds; this was the case, for example, in Sweden and Russia in 1991 and Mexico in 1994.

Given the long-term imbalance of social insurance, and the speed with which the situation has deteriorated in the last four years of economic expansion, we cannot possibly claim that things are basically as they used to be and that only minor adjustments are needed unless we intend to wait for a hard landing to occur. Furthermore, as early as 1998, the combined OASDHI will experience negative cash flow, which will require cash from the federal budget. We are not talking bonds or accounting entries here, but real cash. On a cash-flow basis, the combined social insurance system will be insolvent in 1998. If a recession develops in 1997, the hard landing will probably come in 1998. In Sweden it resulted in overnight lending rate reaching 500%, as the government scrambled to get funds, and a drop in the currency value of 10% in one day. If we allow this to happen, it is quite possible that we will price poor Americans permanently out of the market for purchases of foreign goods. We will have permanent long-term effects, such as very high real interest rates, and very high real cuts in social insurance and social assistance benefits. All these suggestions are not purely hypothetical: they represent events that have already happened in economies that have gone through hard landings (Sweden, Mexico, Russia). There is a real crisis in social insurance.

But there is no political crisis in social insurance. In fact, politicians favoring reforms of social insurance appeared doomed in the upcoming election season. On the other hand, the most successful political campaigns appear to be based on the defense of status quo in social insurance, no matter how impossible fiscally and economically.

Mr. Myers quotes *Webster's* definition of "crisis." I am struck by the adequacy of the concept to our current situation. Mr. Myers is apparently not. I can refer only to the moment of negative cash flow of social insurance, coming soon to the government near you.

Privatization?

Mr. Myers states that all proposals of the AC contain some degree of privatization. This is highly inaccurate. Privatization refers to transferring economic functions from government bodies to the private sector. Privatization took hold worldwide in the 1980s and 1990s, as the world has learned that private markets deliver far superior economic performance than government economic activities do.

Nowhere in economic literature is it stated that government expansion of economic activities is "privatization." In fact, such expansion is normally termed "nationalization." The language of the social insurance debate has truly reached an Orwellian scale, as the proposal to expand the government authority to invest OASDI funds to include private securities, that is, a clear expansion of government's economic functions, is now termed "privatization." But we do live in a rapidly changing world, and in Russia, for example, transfer of political functions from the government to the private sector is also sometimes termed "privatization," whereas it properly should be termed "mafiaization."

Mr. Myers is firmly opposed to this "nationalization-privatization" proposal, even referring to it as "socialization through the back door." The only question one might have is: Where exactly is the back door here?

The AC would be very well advised indeed to read the works of Mr. Myers in which he has been a strong proponent of a strict pay-as-you-go system. There are many reasons why such an approach is desirable for social insurance, one of which is avoiding the dire economic effects of government investment of large social insurance trust funds. It is quite shocking to see the AC adhere to this proposal, which appears to have no basis in any scholarly or professional research on the subject. The 1995 World Bank report on government ownership of productive resources, as well as the 1994 report "Averting the Old-Age Crisis," clearly point out the folly of government ownership of means of production.

At its peak, the Social Security Trust fund will contain nearly 3 trillion dollars. The current capitalization of the New York Stock Exchange is about 6 trillion dollars. One must wonder about the intentions of the proposal for the government to buy stocks of major American private enterprises with taxpayer funds.

Some Conclusions

Mr. Myers's critique of other proposals, which do indeed contain some privatization, concentrates on their effect on the budget deficit. This critique would be fair if social insurance were accounted for the same way as the rest of the budget, that is, if promises of future payments by the government counted as bonds issued, or if all other government functions could net future yet uncollected taxes against future disbursements of funds. It is, of course, not so.

Yes, privatization will alarm accountants. But will it alarm financial markets? I sincerely doubt it. In fact, I would bet my own hard-earned money (truly hard earned: I am a member of the generation that will not benefit from transfer payments in the United States, whereas my parents have been robbed by transfer payments in communist Poland, and I do not intend to abandon my parents) on the financial future of this country, were it to privatize its social insurance. However, privatization proposals have been assailed politically, and privatization proponents' motives are questioned even before their ideas are discussed. Given that, the AC's proposals are half-hearted and lack vision. As a nation, we must ask ourselves about our vision of social insurance. I find only two such visions to be defensible:

- A universal system of truly minimal income support, with most retirement and other insurance provision retained by the private sector (the current OASDI system has grown far beyond that vision)
- Full privatization of the system, with social assistance developed to close the gap for the poor.

Two major points must be stressed here. First, if economic functions are transferred from the government to the private sector, the government's regulatory role increases. "To transfer" cannot mean "to abandon." Second, social assistance functions must be addressed in any privatization debate.

It's the Economy

A version of this slogan was the rallying cry of the 1992 presidential election. In the long run, we must examine the economic effects of social insurance. In our current political climate, critical examiners are generally assailed. Yet it is crucial to the future of the nation that we examine the reasons for our current low growth trend, low savings rate, and low productivity growth. All hypotheses about reasons for these phenomena, as long as they are reasonable in nature, should be on the table. Another recession will occur sometime in the future. We have a big hole in the long-term financing of social insurance in a period of recovery. Indeed, one could call the current growth period "the most wasted recovery of the twentieth century."

What will happen when the next recession arrives?

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