Does Social Security Reform Have a Future?

Proceedings from the 59th National Conference

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Social Security System is something that is being talked about and written about increasingly. Studied, the discussions are slowly working their way out of the think tanks and into legislation and public debates such as this. College students and graduate students make up a large part of our audience today, and guys, this affects you. You may not be in the workforce yet, but if things are allowed to continue as they are, when you start paying payroll taxes you probably would not see much of it back. You need to understand what is going on and what the solutions are this really is about your future.

The Social Security System is in trouble because it is going to run out of money. It is as simple as that. It is going to run out of money about the time that the college students in this room are going to be expecting to receive something from it. There is not going to be anything there, as it currently stands. So, there is going to have to be a solution. And people are starting to talk about what that solution might be. I believe outside we have a paper that one of our economists did, Dr. Arthur Hall. It's a premier on Social Security, and it kind of lays out some of the basic issues about the fiscal disaster that is heading our way, as well as some of the investment comparisons that Social Security offers for you. We have, I think, a great program for you, and I am delighted that you are here for it.

Our first keynote speaker, I think you can fairly say, is the lead legislator in the United States Congress on Social Security reforms, he is the fellow who had the courage to come out with the bill and start pushing and has done so very actively. Following the keynote speaker, Mr. Brent Bahler will give us a quick review of some of the fascinating survey polling results that he has generated. After Brent has concluded, we will move into the room across the way, to continue the conference. We are going to hear from Michael Tanner of the Cato Institute. You have to give Cato a lot of credit, they got out in front on this early on, and Mike headed a tremendous program of getting Social Security reform on the map. Responding to what Mike says and adding to it will be Dr. Arthur Hall of the Tax Foundation. After that Dr. Ricardo Zaba of Citibank, who is an expert on the reforms that were put forward and enacted in Chile awhile back, will tell us how that has worked, and John Goodman of the National Center for Policy Analysis will add to that his experiences and what he has learned about similar reforms from other places in the world, such as Singapore. Mr. Steve Entin of the Institute for Research on the Economics of Taxation will provide us with an overview of what some of the options for reform might look like. He is not going to go through it on a bill by bill basis, but rather tell us the conceptual issues that have to be addressed and some of the consequences. And then Mr. Mark Weinberger, former Chief of Staff of the bipartisan Commission on Entitlement Reform, is going to add a little of what he has learned on this same topic.

I would like to turn it over to our keynote speaker, Congressman Nick Smith of Michigan, the author and lead legislator on a tremendously important piece of legislation in last Congress which I assume he will reintroduce in the next Congress.

Keynote Address: “The Entitlement Crisis”

The Honorable Nick Smith, Member of Congress (R-Michigan)

A story I like to tell is the joke of the member of Congress and the doctor and the attorney who took a junket to Europe they got into Paris and they got into trouble. In fact, the trouble was so serious that they were sentenced to be executed by the guil-
lotine, and so after days and weeks went by finally they got on the platform, ready for the execution. First the doctor got up there and they asked him for his last words and he explained how important his work was for humanity and how many lives he had saved. But it did not seem to make a difference, so the executioner pulled the rope and the guillotine blade came down, and it stopped about that far from his neck, and the bureaucrat looked in his book and said, "That's an act of God, you may go free." Next was the attorney, and then about a half hour later he finished why he should not be executed. But it did not make any difference. But again, when the blade came down it stopped that far from his neck and the executioner said, "Well, that's an act of God, you can go free." Then the congressman stepped up, and as he was asked to give his last comments, he started chuckling, and he told the executioner, "Boy are you guys dumb. That's not an act of God. There's a snarl in that rope up there."

It seems like that kind of a story is sort of a good introduction for what Congress and many state legislators have been doing in making decisions that are leading us into greater problems for the future. We now have a federal debt of $5.2 trillion, but that's really just the tip of the iceberg. If you look at Social Security, the unfunded liability or the actuality debt, it's about $7 trillion, and if you add Medicare to that it's 8 trillion. Then the promises we made for military and other federal retirees, which adds another $2 trillion to that. Tremendous obligations, and who it's going to fall on is the people most at risk, those of you under 30 years old. And so as we look at Social Security, it seems to me that you should be on your soapbox demanding that members of the United States Congress and those individuals that are running for the presidency of the United States acknowledge the seriousness of politicians' tendencies to over-promise and give out more things for people because they have discovered that is a good way to get re-elected.

Social Security started in 1937, and Social Security is this country's largest and highest cost program. And as we think about changing Social Security it is important that we realize how big a part it plays, not only of our budget, but in retirees' lives. Right now it takes up 22% of the total budget pie. But if you add Social Security and Medicare together, then we see it is going to take a 50% increase in the taxes in the next 30 years just to cover those two programs. But I want you to look at something else while we have this pie chart up here, you see at the top of the pie where it says domestic discretionary spending 12%? That represents 12 appropriation bills that Congress has control of. Most of the rest of the spending is on automatic pilot. If you add in the 17% that is represented by the 13th appropriation bill, which is defense spending, everything else is entitlement programs or interest. Entitlement programs simply means that if you reach a certain age or you reach a certain qualification then you are eligible for that welfare program or that food stamp program, or that retirement program, or Social Security, Medicare or Medicaid. But here Congress has lost its control over the expenditure of federal funds. That's why we had such a trial earlier this year and last fall. It is simply because Congress was trying to say to the President, look, if we are going to pass these 12 appropriation bills plus defense, we are going to try to tie on language that leads us into dealing with the entitlement programs.

Now here is the danger. Republicans tried to come up with their ideas on the best way to change Medicare. Tremendous negative results in the past election. Republicans got beaten up for their proposed changes in Medicare by misleading advertisements, which ended up being very effective. But where does that leave us in terms of politicians efforts to make the changes that are necessary, not only in Medicare, but Social Security?

You know Social Security has always been a three-legged stool, if you will. The three legged stool was pensions from an employee's company, savings, and Social
Security. It was never meant to be the total retirement pot for retirees. But what's happened now is Social Security represents most of the retirement income for most of the retirees. In fact one out of four of every retiree depends in effect totally on just the Social Security check. Social Security was never a savings program, but was always a pay as you go program where current workers paid for current retirees. When we started in 1935 there was a big argument in the United States Senate at that time. They said, look, a worker should have the option of mandated investments in their own private investments or turning it over to government for letting government control, manage and invest that money. Well, in conference committee the Senate proposal was kicked out and it became totally an investment in treasury bills.

In 1983, when we had the Greenspan Commission, they decided they were going to fix that problem. At that time the unfunded liability or actuality debt was an additional 1.8% of payroll. In other words, if we increase the payroll tax by 1.8% they could satisfy the problem. Today, the problem is 2.19%. In 1983 they thought they could solve it simply by increasing the tax, and increase taxes on the workers they did. It has caused a temporary surplus coming in. You see the little blip on the screen, where is says short term surpluses? That's because of the increased taxes brought in more money than is necessary for the day to day pay out for Social Security. Dorcas Hardy, a former commissioner of Social Security says, that we are going to run out of money as early as 2005. So you either have to borrow money, which puts more obligation on the young people for the future, or you are going to have to increase taxes. And I think that its a good chart simply because in current dollars it gives you an impression of how much we are going to have to borrow or how much we are going to have to increase taxes to account for the $400 billion that we are going to eventually have to get from increased taxes or borrowing to meet our obligations in the next 60 years. It seems to me that because of the fact that it is a pay-as-you-go problem, because there has been no savings, and because of the fact that Americans are living longer, we are moving into a very serious situation of how do we meet future obligations. The little blip on the bottom line is simple the current law that increases the normal retirement age over several years from the existing 65 years old to 67 years old. But you see what's happening to life expectancy. Not only are we having more seniors retire, especially when the baby boomers start retiring in 2014, but people are expected to live longer lives. When we started Social Security in 1935 the average age at death was 65 years old. In fact, half of the people died before they reached that age group of 65, so one reasonable solution to start modifying the program is to increase the eligible age for retirement. At least from 65 to 67, maybe to 69. Some people on life expectancy say that by the year 2050, if you reach the age 65 your life expectancy could be as high as 100. So it depends where we go on medical technology.

If you understand how Ponzi schemes work, you know that those people who for instance get a chain letter started earliest are the ones that come in with the rewards. That's what's been true here — current workers pay for current retirees. The early retirees have an assurance of getting all of their money back very early. In fact, in 1947, there were 42 people working for every single Social Security recipient. By 1950 we came to 17 people working for each current recipient. Today, paying into the system with our FICA tax, with 12.4%, we only have 3 people working for every retiree. Guest where it's going to be when you college guys retire? By 2020 there's going to be 2 people working paying for every recipient, and it continues to get worse. So, that relationship of a slower increase in workers and a rapid increase in those above 65 years old is what compounds the problem. I want to talk about this, because usually people don't really want to look at any solution until they ap-
preciate a little bit how serious the prob-
lem really is.

This slide shows the projected popula-
growth of seniors. So workers increase
between now and 2040 23%, where seniors
increase 108%. Right now we call Florida
the senior citizen state, because there is one
senior citizen for every five people under
65 years old. That's what the whole coun-
try is going to be 30 years from now.

Let me just give you a short history of
where we have been on Social Security and
the changes. It started out in 1935. When
a little more money came than was needed,
we saw politicians expand the program. So
in 1939 we extended the coverage to wives,
widows, and dependents. In 1950, cover-
age extended to widowers. 1956, disabil-
ity coverage begins, early retirement age is
62 for women. 1958, disability coverage is
expanded, but there are still a lot of work-
ers for those in retirement, so the money
and surpluses were still coming in. 1961,
the early retirement age was extended to
men. 1965, the benefits for divorced
women began and the widows benefits are
expanded. What we started in 1973 was
COLAs. COLA means an automatic cost of
living increases based on the CPI projec-
tions. Politicians decided that retiree's
should be home free and should automatic-
ally have their Social Security benefits in-
creased based on what was happening with
inflation. Now the projection is that we
have been overestimating that COLA in-
crease for the last ten to fifteen years. As
we look at the Social Security tax increase,
this is just a chart that shows that the way
we solved the problem before was simply
to increase taxes on existing workers. We
started out with a two percent tax, which
employers and employees shared when we
started collecting that tax in 1937. Now
we are up to 12.4%. But it is worse than
that. We have increased it from that two
percent being a tax on the first $3,500 you
earned, to a 12.4% tax on the first $62,500
you earn now. So we have been increasing
not only the rate, but the base. Since 1970
we have increased the taxes on workers 36
times. And just think, we cannot continue
to increase that tax to solve our problems.

When people call for a 24% to 50% in-
crease in taxes to cover the increase cost of
Social Security and Medicare, I think we
need to remind ourselves that this is a very
regressive tax. Because in Social Security
we only tax up to a certain level of income
and then the higher income people do not
have any Social Security tax. So it tends to
be a regressive tax, which means that the
taxes are a little more burdensome on poor
people than on rich people.

Let's go into our program and some of
our proposals that we have come up with.
My bill would:

1. Give worker the option of owning a
personal retirement savings account. Let
me tell you why everyone is talking about
this as an option. The present Social Secu-
imity Administration is now arguing about
three different proposals. But all of them
look at some kind of a private investment
in equity stocks because the return on eq-
urity investment over the last fifty years av-
neraged about 9% compared to Treasury's rea-
return on investments in Treasury Bills of
2.3%. So my proposal includes partially the
private investments that are going to allow
anybody to have more than they would.
Even if we could find ways to keep the cur-
tent Social Security system solvent, they
would actually have more income if they
could get a return on their private invest-
ment over 4.4%.

2. Stop the federal government from
using surpluses from Social Security to pay
for other government programs. There is a
feeling, and Brent I suspect that you ar-
 Suspect that you are
going to talk about this, but my experience
is most people think that somehow they
have invested money into the program and
it is some kind of savings program. So there
are a lot of people who do not understand
that we spent every cent that they ever put
into the program to pay for existing retir-
ees. In other words, it's a pay-as-you-go pro-
gram, where existing workers pay for cur-
rent retirees. But with the federal govern-
ment using these surpluses for other gov-
ernment expenditures, that further complicates the problem. In the Social Security Trust Fund right now is about $535 billion, but there is no real money there, just IOUs. They are not saleable, they are non-negotiable securities and Treasury bills. Even so, most people say, "Look if you keep your cotton picking hands off that Trust Fund then we would have enough money." Actually this money in the Social Security Trust Fund would last about 18 months, paying current Social Security benefits. So you should not get your hopes up too high on some kind of salvation for the Trust Fund.

But this brings up the problem, where do we get the extra money from? The only way that you are going to get more money is to increase taxes on workers or borrow the money, which means that young people someday are going to have to end up paying that debt back plus the interest on that additional debt, which becomes an increased burden.

3. Gradually raise the Social Security retirement age two years more than the existing 67. So by the year 2020 you would have to be 69 to retire.

But what we do is sort of an offset to that. In number two we say for that money that you privately invest, which represents about 2.5% out of the 12.4% Social Security tax, you can take that out as early as age 60. So depending on the other two legs of the old traditional three legged stool, if you are ready to retire at age 60, you have got enough money to last you until Social Security kicks in and you can retire anytime you want to. So you can take out your personal savings investment account as early as age 60.

4. Gradually slow the growth of benefits for higher income future generations. If you understand the bend points and you understand that Social Security benefits are dry from 35 years of earnings, and you average that down to the month, then the lower income earners get 90% of everything they made, then the numbers sort of stair-step up, with 32% of the next earning segments after that, 15% of that and so on. That's how you decide what your benefits are. My bill gradually changes and slows down the increase in benefits for the higher income recipients, and that makes us some money.

5. Gradually reduce the benefits to individuals who make over $50,000. In 1993, when I first came to Congress, this is part of the bill that I introduced then, and it simply says that if you have gotten everything back that you and your employer every paid into social security for the social security tax, plus the compounded interest rates that Treasury was paying in each one of those years, if you got everything back that you and your employer put in plus roughly a 2% compounded interest from day one of the first payment, and then any year that you make over $100,000 you would not get social security payments for that year. So some means testing, but what I consider fair and logically in terms of requiring that you gotten everything back that you put into it, plus a compounded interest.

6. Gradually reduce the married couple benefits. Right now if one of the spouses did not work or had a lower income entitlement, we guarantee 150% of one individual's benefits. And this gradually reduces that down to 133% by the year 2016.

7. Would require that everybody start participating in Social Security including state and county workers that now have the option of not being included in Social Security.

8. A technical change that allows the money in the Social Security system to stay in the Social Security system.

Let's quickly look at what's going to happen to the tax rates as we try to cover that particular year's requirement for payout to existing Social Security retirees.

You college folks should talk to your grandparents to learn how they lived in the late 20's and early 30's, because if you don't start saving some money you better understand how cornmeal mush and onion soup can be quite nutritious in your old age. Make sure that you don't travel very far and you have a small room to live in so that your
heat costs are down.

In local surveys, young people think the chances are more likely that life exists on Mars than that they are going to get their own Social Security benefits when they retire. Yet at the same time, there is less effort to save today than there has ever been in the past. So, something is inconsistent. There is no magical solution down in Washington that will either reduce benefits or increase taxes to save it. If you happened to retire in 1940 on this graph, you got back everything that you and your employer paid into it, plus the compounded interest in two months. If you retired in 1980, it took you four years to get it back. You folks that retire in 2026, stay healthy, because you are going to be about 100 years old before you get it back.

It think that the word from Washington is that the Republican-controlled Congress is probably going to move down the same road that it has been moving, in terms of lowering taxes and reducing spending. There is a strong feeling that we continue to make sure that we cut the spending necessary for any tax cuts, so we still meet the target of a balanced budget by the year 2002. But we are even very generous with using the words balanced budget, because in the Republicans' balanced budget plan, in the President's balanced budget plan, in the Blue-Dog Democrat Coalition balanced budget plan, to balance the budget by 2002 they are still using approximately $100 billion from surpluses in the Social Security Trust Fund.

"CSE SURVEY ON SOCIAL SECURITY"

Mr. Brent Bahler, Director of Communications, Citizens for a Sound Economy

The Social Security system is on a steep decline and headed for a crash, and one of the things that we at Citizens for a Sound Economy have been looking at is public opinion and how the general public looks at this issue.

One of the wonderful things about our country is the opportunity that all Americans have to participate in the process that develops and decides public policy. Having said that, it must also be noted that one of the worse things about America is that Americans either individually or collectively are generally confused about what it is they want out of public policy. At any given moment, on any given issue the public may seem to be in agreement or it may not. Yet that unanimity, or lack thereof, is a reflection of this particular moment in time based on the unique perceptive of the individuals who make up our society, responding to the issue as they know it. And one thing that we have learned in policy making is that the average American doesn't really know a whole lot about these issues.

We saw that in the great health care reform debate of 1994. At the start of the year you may recall a large majority of Americans told pollsters that they supported President Clinton's call for universal health insurance for everyone. The problem was, at the time the pollsters asked the question, no American had read the fine print of such a program. Indeed the fine print did not even exist until months latter. Up to that point in time, if I might characterize them as such, the liberal community had carefully built the case that America's health care system was in crisis. That too many Americans could not obtain health care insurance and that as a consequence, too many Americans were going without adequate medical care. There
was a need, they claimed, for radical reform. They were, simply put, going to come up with a better mousetrap.

I for one believe that the early public support for health care reform was rooted more in the typical American’s notion of what was wrong with the system from their perspective, not some altruistic ideal of taking care of other people. After all, most Americans had health insurance. But a majority of them didn’t necessarily like the system as it applied to them. This was the concern, rather than some overarching concern for the minority of people who weren’t even in the system.

We still see that today, just as the $500 hammer and the $1,000 toilet seat symbolized problems with the procurement system of the Pentagon. The $10 your local hospital charges for a single Tylenol seems to symbolize something wrong with America’s health care system. So it is not surprising to me that when the details of a new “mousetrap” were put before the public, public perceptions began changing very rapidly. Even in the pursuit of that altruistic, noble goal of providing all Americans with insurance and consequently medical care, the liberals’ proposal of reform could not hold a candle to the opposition which defined health care reform of 1994 as ultimately placing a bureaucrat between patients and their doctors even if you already have health insurance. What I am saying is the public’s opinion on any issue is a very fluid thing, very dependent on what people think they know, what they actually don’t know, and how they see the issue affecting them. Especially in the short term. After all if you have never seen a mouse, you don’t think you need a mousetrap.

So where is the American public on the issue of Social Security reform? Well, it depends. It depends on who you ask and it depends on when you ask it. The public’s opinion on this issue is different today than it was two decades ago. In November 1977, for instance, a Harris survey of 1,498 adults asked, and I quote, “Would it be better to go over to a totally private system of pensions and abolish Social Security since it has not been on a sound basis?” 49% thought no, do not abolish Social Security. Only 28% said yes. Now, one would have thought that since the question was biased, noting that the system “had not been on a sound basis,” that the response might have been far different, for more favorable to the idea of reform. Yet consider when the question was asked. In 1977, a great many of the respondents would have had personal memories of the Depression and of World War II, two of our countries most significant national experiences in which government made a difference. A positive difference in the eyes of those who were answering the questions. And I think they would tell you that government played a positive difference at that time, that’s why when you look back to the Depression and World War II, Herbert Hoover was upstairs here in the Waldorf and Franklin Roosevelt was in the White House.

Similarly, a 1982 survey of 1,583 adults by NBC and the Associated Press asked whether people would favor “phasing out Social Security altogether and instead having people rely only on their own private retirement plan.” Again, 78% opposed this idea, while 16% supported it. Now here I should note that the question was, in my opinion, biased against reform by the phraseology “rely only on their own private retirement plan.” To which any responsible person, or reasonable person might ask what about those who don’t have their own private retirement plan. That’s certainly a reasonable question. Yet the respondent could reasonable infer that there would be no safety net for those who, through no fault of their own, could not afford to have their own retirement plan.

Now let’s go forward a little bit in time to January 1988. After seven years with President Ronald Reagan in the White House and just several years after the Social Security financing structure was fixed to avoid bankruptcy, or at least tinkered with to avoid bankruptcy sooner rather than later, a Gallup survey of 2,109 adults asked whether people would be more or less likely
to vote for a candidate who "supports a tax free private savings program to replace the Social Security system in the future." 38% were less likely to vote for such a candidate. 36% were more likely to vote for such a candidate, and 26% where undecided or just didn't care. Not bad given that the polling numbers just a decade earlier showed great resistance to the idea of changing in any radical manner Social Security. The times were changing, however. The number of depression and World War II voters had declined from a decade earlier. Ronald Reagan's leadership was redefining the role of our government in our lives and economic times were good. In short, peoples perception at that time in 1988, what they thought they knew, what they actually knew, and how they say the issues affecting them in the short term were in fact changing.

Earlier this year in July, 18 months into the new Congress, a Yankelovich survey of 1,010 adults by Time and CNN asked if much of the Social Security system should be turned into a "private retirement system that would no longer be funded completely by the federal government." Now again, given the time and how the issue had been phrased, in the middle of this Republican Congress, 53% opposed that proposition, while 39% supported it. The results, however, again could be eschewed by the question's phrasing, which basically said that the current system is funded by the government. Yet more and more Americans are becoming aware that the system as we know it is in very ill health. And for the growing number of babyboomers and Generation Xer's, when they think about it, the future of Social Security is serious concern.

Just over two weeks ago, Citizen for a Sound Economy commissioned a series of questions on election night on this very issue. The polling company survey of 1,200 adults asked if people agreed that "Social Security is in need of serious reform if it is going to remain financially healthy for those currently on it and those counting on it in the future." This time, and admittedly we had the question the way we wanted it, 92% agreed, while just 6% disagreed. Now within that 92% who favored serious reform, 82% said Congress should make reform a top priority in the next two years, 42% said we need it for the future of both our children as well as ourselves, 23% said the system doesn't take care of senior citizens as it now exists, and 20% said the current system is simply an outdated system. But before we all rush out and privatize Social Security or go down any particular path, consider this last question asked by the polling company: "Should people be able to take their Social Security tax, the whole whopping 12.4%, contributed by them and their employers, and be able to invest it in a private institution knowing the likely return would be four times greater than that from the Social Security program". Only 54% said yes, while 35% said it would be too risky.

These results led me to Omaha, Nebraska. Not to seek the views of Warren Buffett, though that wouldn't be a bad thing. But rather to seek the perspective of average Americans about their retirement future. Earlier this year Citizen for a Sound Economy commissioned a pair of focus groups with middle income men and women in Omaha. Well educated, not so well educated; rich, not so rich; and middle incomers to talk about the future of Social Security. Now what we did on this one, we restricted the participants to babyboomers age 30-55. And we asked them what is likely to happen and what they would like to happen. Unlike surveys which are quantitative snapshots of the American public, focused groups are qualitative. Where surveys can help explain what the public believes, focus groups, done properly, can help explain why it believes what it believes. Our focus groups offer advocates of Social Security and policymakers, who will have to chart the new course, both good and bad news. First the good news. According to our focus group participants, and we think they are fairly representatives of what you find in most any part of the country, the future of Social Security is a real issue, especially for women. The program
is viewed by many to be part of a larger overall problem of government living beyond its means and being out of touch with its citizens. There is a general awareness the system is on a path of financial peril. Now, while our focus participants believed that at least up until now Social Security is viewed as a success in as much as it provides a safety net for the disadvantaged, they do believe that it’s a program designed for a different era and is becoming obsolete.

Now the bad news. Our focus group participants are fairly unsure of their own retirement security. While support for being able to opt out of the government system is strong, few want to do away with it altogether, with the government system. While they recognize that they could in fact do better with a private system, they admit they lack the discipline to participate in a voluntary plan. And they worry about the consequences as it will apply to them down the road.

And I would ask if anybody doubts this among our college students out there. How many of you currently, right now, have a regular retirement plan that you are paying into on a monthly basis. One, two, three, four, five. We could meet at a Denny’s and plan your retirement. Everybody else is going to be left behind. This is a problem that we face with a majority of the boomers in our focus groups. Remember, these are people 30-55. So chances are they are settled into life, married, have children, good jobs. While they admitted to having their own private retirement plan, many conceded that they lack the expertise to manage a plan that would be their sole source of income. Even as they concede that they don’t expect to get a dime back from Social Security, what they have paid into it, they worry about the security of the private markets and also wonder if there would be something like a FDIC to protect them against bad decision making.

Now some might ask why our focus groups were restricted only to baby boomers. Well, we zeroed in on this group because we have a general feeling that the current recipients of Social Security are comfortable with the status quo and would argue for no change in the system, at least as it applies to them. We saw that last year with focus groups with AARP members on the issue of Medicare reform. And we see no evidence to suggest that seniors are any different on this issue. Baby boomers have yet to become addicted to Social Security, if that’s the word we can use, and could therefore be viewed as a left-wing audience. They are in effect a jury that is still out on the issue, on any particular plan. Boomers do, however, hold some attitudes that seem to be directly descended from their parents. When asked about different types of reforms that can be linked to the existing Social Security System, we heard the following:

Don’t raise the retirement age. Boomers want to retire early and they want access to their money.

Don’t limit or reduce benefits and be careful of means testing. Boomers are a more affluent generation and they don’t want to be penalized for it.

Don’t mess with the consumer price index to calculate benefits. The next generation of retirees are not wed to the status quo. To them Social Security may or may not be there. But they are anxious about what might take its place. They want to maximize their investment. They want to minimize their risk. They are concerned about the disadvantage. They want to see reform that can accommodate the least able among us. Aside from current recipients of Social Security, the next generation, the baby boomers, that’s the most important voter group that Congressman Smith and others who challenge him on different ideas for reform will have to pass muster with.

And while surveys and focus groups should not dictate when change occurs, or what totally defines the shape which reform should take. We should at least consider the information we have about public attitudes, if for no other reason than to avoid taking action or making blunders that in the end doom our efforts at real reform of society’s approach to retirement security. After all,
even the builders of mousetraps do market research to come up with better products. Build it and the public will come.

**Presentation 1: Problems and Promises**

"An Examination of the Need for Reform and the Macro-economic Benefits of Reform"

**Presenter:** Michael Tanner, Director of Health and Welfare Studies, Cato Institute

I want to tell you I appreciate the opportunity to talk about this issue, because I really believe this is going to be one of the two or three most important issues facing this country over the next three to five years, let's say. That this is going to be an issue that's going to drive congressional debates, debates in the media, debates on Wall Street, and debates in the public. So I really appreciate what the Tax Foundation has been doing on this issue, as they've done on so many other issues, such good work in terms of raising the level of knowledge of the really important issues in economics and other things facing this country.

Now when I start off to talk about Social Security, one of the things I want to say right up front is I'm not here just to beat up on Social Security. As you heard at lunch, Social Security is regarded as perhaps the most popular of all government programs. And it is for a reason. As people generally believe, it has, for 61 years now, largely been successful at what it set out to do, which is to cut poverty among the elderly and ensure that seniors can retire with dignity. But in saying that, I'm reminded a little bit of the fellow who jumped off the Empire State Building down the street here, and people at each floor could gather at the window and watch him fall. And at each floor, as he passed by the window, people heard him exclaim "Well, so far so good." The problem, of course, is at the bottom there comes a big splat. And unfortunately, that's exactly what's going to happen with Social Security: We have a big splat coming.

As Congressman Smith shared with you at lunch, I want to review a little bit of this
stuff on some of the problems the Social Security system is facing. I know you've just heard much of it, so I do want to just sort of cover this ground fairly quickly, but I think it's important information to go over again. This slide comes from the Bipartisan Commission on Entitlement and Tax Reform. I understand you've got Mark Weinberger speaking a little bit later, so he'll recognize this slide. This is actually out of date now, by a year. According to this slide, the Trust Fund will be exhausted in the year 2030. That's wrong now; this summer, the trustees of the Social Security Administration brought out their latest report and they reported that that date is now down to 2029. That actually represents the seventh time in the last 10 years that the trustees have reduced that date. It's moving towards us almost as fast as we're moving towards it.

But I'd like to suggest that the real crisis in Social Security actually occurs far, far sooner than that date. If you look at those lines there on this slide, you see the red line is almost flat. That's the revenue to Social Security. That comes from the payroll tax and also the portion of Social Security benefits that's later on taxed and paid back into the system. You can see that that's almost flat. The yellow line represents the benefits that Social Security must pay out under current law. As you can see, beginning around 2013 in this slide, and that's actually moved down a year so now it's 2012, the two lines cross, and Social Security begins to pay out more in benefits than it's taking in in revenue. Now anyone out there who's running a business understands what happens as soon as your bills begin to exceed the amount of money you're bringing in. And that's exactly what's going to happen with Social Security.

Now, the theory behind Social Security, what you'll hear often, is that Social Security is building up a surplus in the Trust Fund and beginning in 2012 we'll reach back into that Trust Fund and will use the money in the Trust Fund to continue to pay benefits until 2029, when the Trust Fund is exhausted. There's only one problem with that little scenario, one of the dirty little secrets of Washington: There ain't no Trust Fund. The simple fact is that money that has been put into the Trust Fund, building up that surplus, has been spent long ago. That money, as soon as it goes in, is immediately borrowed by the federal government and used to hide the actual size of the federal deficit. Here's another dirty little secret from Washington: Right now you're hearing about all the plans to balance the budget by 2002. President Clinton has a plan maybe, the Republican Congress has a plan. Well, they're all lying. The simple fact is under none of their plans, the budget actually balanced in 2002. The simple fact is that come 2002 we're still going to be about $50-60 billion out of balance. It's only called "balance" because they continue to borrow that money from the Trust Fund and use that money to hide the actual deficit. What's used — what's left behind after they borrow that money — is two things. The Trust Fund actually consists of no money, it consists of, number one, bonds. Bonds are essentially an IOU; they are a promise that at some date in the future the government will tax somebody in order to pay and make good on those bonds. The other half of the Trust Fund doesn't even have that much substance. All it is is an accounting entry attributing interest to those bonds. So all it is is an accounting entry saying one part of the government owes another part of the government money.

Now, the Social Security Administration will disagree with me, and I've had Administrator Shirley Chater and others tell me, they'll say, "Those bonds are as good as gold. Those bonds are as good as the bonds in everybody's investment portfolio out there. The bonds are absolutely solid, so don't worry about the Trust Fund." But that's absolutely irrelevant. Think about this for a minute. What would happen if there were no Trust Fund at all? Well, beginning in the year 2013, the year after the crossover there, they'd have to raise taxes in order to continue to pay the benefits. All right, now let's assume that Shirley Chater is right, those
bonds are as good as gold. What happens in the year 2013? They have to raise taxes in order to make good on the bonds to pay the benefits. It makes absolutely no difference whether there are bonds there or not. An IOU may be good, but it's still an IOU. So what you've got is this situation that is coming much faster than anyone commonly talks about when we talk about how Social Security is going broke. And I'd also like to point out another thing on this chart which will show you how bad the problem is. This left-hand scale here is the payroll tax that people pay right now. As you can see, the revenue currently right now is around 12.4%; that's what the payroll tax is right now that's funding the Social Security system. As you can see, though, if you're going to pay all the benefits out there in 2029, in order to pay all the benefits that are promised, that payroll tax would have to increase to about 18%, from the 12.4% it's at now.

Now I'd like to say this is the bad news; unfortunately this is the good news. Because that only takes into account Social Security. We're not mentioning Medicare here. See, because Medicare, which is already running a deficit and will be broke — actually the latest report was by the year 2000, but I now understand they're up on the Hill spreading the word that it's actually going to be 1999. So Medicare will be broke in 1999, but Medicare will be running huge deficits during this whole period of time as well, Medicare Part A paid out of the payroll tax. If you're going to make good on the Medicare Part A promises, that combined payroll tax goes up from 15.3%, which it is now, to about 28% payroll tax.

Now I'd like to say that that's the bad news, but unfortunately we're still dealing with good news here, because that uses what the government considers its intermediate projections. And I should say the government's intermediate projections assume that between now and that 2029 date, there will be no major natural disasters, there will be no recessions, and there will be no increase in life expectancy. They couldn't be wrong. If they are, two things happen: First of all, all these dates rush towards us at an enormous rate. If we have one big recession, that date from 2012 could move down to 2008 or 2006. And the amount of payroll tax necessary to pay off all the benefits under combined Social Security and Medicare could have to go to 40%. That's why Larry Kotlikoff from Boston University points out that a young person today, in their lifetime, between the payroll tax and the income tax will end up facing a marginal tax rate of about 84%. Obviously that is not sustainable. Obviously this system cannot go on.

If you can't raise payroll taxes, of course, you could cut benefits by a huge amount. We estimate right now benefits in Social Security are underfunded by about a third, so you could cut people's benefits by about a third. And you could do that directly, I suppose; you could just cut everybody's check by a third, but that's going to have a huge impact particularly on the elderly, particularly on the poor elderly. Now it probably wouldn't affect me too much, it probably wouldn't affect most of the people in this room. But the fact is, that of the poorest 20% of elderly, they derive 81% of their post-retirement income from Social Security. They rely on it. Cut their checks by a third and you're going to have a lot of people thrown into poverty. Or you could do it indirectly by raising the retirement age and things of that nature, but that's going to make worse another problem which Dr. Hall will talk to you about, which is the return that you get on your Social Security investment. It's going to make that problem much worse, and that's also going to have a terrible impact on the poor. Let's face it, it's a lot easier to work until 70 if you're shuffling papers like I do than if you're working in a coal mine.

The reason why you have this problem is very simple, and you heard about it earlier. It's similar to the Ponzi scheme that you heard about earlier from Congressman Smith. The fact is, there are people serving prison sentences in every state in the Union for operating less egregious pyramid
schemes than Social Security. In 1950, you had 16 workers paying into Social Security for every person who was retired and taking out benefits. Today you have approximately 3.3. By 2025, you'll be down to 2, and that actually moves below 2 and starts moving down towards 1 towards the middle of the next century. So theoretically by the time your grandchildren retire, they can rely on one person to take care of them; you could just have the check mailed directly to them, and not have to go through the government middleman at all. But you can't — there's no way that you can make a system based on this sort of demographics work.

Now we're hearing out there right now from people like the AFL-CIO and some folks in AARP and the National Committee to Preserve Social Security who say, "Oh, we could fix Social Security with tinkering." Take a look at that. You can't make that sort of demographics work in a pay-as-you-go Social Security system.

Now I mentioned there was another problem besides solvency in Social Security because you could make Social Security solvent. You could raise the pay tax, you know, to 40%; I suppose in theory you could do it. You could cut benefits sufficiently to do it. You could, if we doubled the economic growth rate in this country, keep Social Security going for quite a while. I don't think it's likely. If we allowed into this country about a million new immigrants every year for the next 30 years and then sent them home before they collected their benefits — that might work.

But even if one of those miracles took place, that doesn't solve the other problem with Social Security, which is quite simply that Social Security is a lousy retirement plan. As you've heard, people who retired 10-15 years ago did very well under Social Security. Someone who retires today will receive a positive return, but they're not going to do so well. And for those college students out there, by the time you retire, you're going to lose money under Social Security. You'd be better off if you just took your money and stuffed it in a mattress than if you relied on Social Security. But it's not just that you're going to lose money in the system, and I know Dr. Hall has done a lot of work on this and he can give you some more details on it. But it's what you're losing in terms of potential income, in terms of what you could have made if you actually were able to invest this money yourself in the private sector. We had a study that we commissioned by Bill Shipman, who's with State Street Global Advisors in Boston. And I know you can't see all the numbers on here, I just want to give you a brief idea.

What he did was he took three cohorts: People born in 1930, 1950 and 1970. He took a high wage earner, which is someone who earns $61,200 average over his lifetime. And he took a low wage earner, someone at half the median income, about $12,600 a year. And he said for those individuals, what are they scheduled to get under current law for Social Security, assuming that Social Security finds a way without cutting benefits or raising taxes to meet all its obligation? What are they scheduled to get under current law, and what would they be able to get if they were able to privately invest that money in either bonds or stocks? What he found was that in every case an individual did better in the private investments than under Social Security. And not surprisingly, the younger you are, the better you would do from the private investments. And I just want to call attention to these 1980 numbers, and I'll read them off to you so you can actually get them, because I know you can't read them on this chart here. For the high wage earner — making $61,200 a year, who is 26 years old today, and will retire at age 67 under current law — they are scheduled to get from Social Security a Social Security check every month of $1,908 a month, in 1995 dollars. If they were able to take their Social Security taxes and were just taking the OASI portion, just the retirement portion, no disability in here at all, just the 10.52% that goes to retirement portion of your Social Security, and invested that money in bonds, and the bond market over the next few years performs about 2 points
worse than the bond market has averaged over the last 60 years, they would be able at retirement to purchase an annuity that paid $5,243 a month. And if you took that money and you invested it in the stock market, and the stock market performs about 2 points worse than it has averaged over the last 60 years, you would, at retirement, be able to purchase an annuity that pays you $11,729 a month — six times what you could expect from Social Security.

The same is true for the low wage earner. The low wage earner right now is scheduled to receive $769 a month from Social Security — not very much to live on. But if you invested that money in bonds, you could purchase an annuity worth $1,085 dollars. If you invested that money in stocks, you'd be able to purchase an annuity worth $2,419 a month. I can give you all the assumptions behind this later if you're interested.

That's the situation we currently have in Social Security. And if you do the things they're talking about, just CPI, raise the payroll tax, cut benefits, raise the retirement age, any of those situations, you're going to make that discrepancy even worse. And that's something to bear in mind. Solvency is not the only issue.

I want to offer you an alternative. I want to give a suggestion. Because there are alternatives to doing the traditional things, raising the payroll tax, cutting benefits. That alternative is to transform Social Security from a pay-as-you-go system into a system of individually-owned, privately-invested accounts. This is what they have been doing in Chile for the last 16 years. And you'll hear much more about this; I understand you've got an actual review scheduled this afternoon on the Chilean system, so I'm not going to go into any depth on that. What I can tell you is that every Chilean worker has a passbook. This is an actual Chilean passbook carried around by a Chilean worker. And in this passbook they record exactly what their payments are into their individual account. It comes out of their paycheck the same way Social Security is deducted today.

Instead of going off to the government, it goes off into a private account which is recorded and managed by a private money management firm. And that money has been invested in the private capital markets, given the type of returns that you've just seen. What you receive at retirement is based on what you've paid into the system, plus the return — the far greater return than Social Security — that you get from your private investment.

Now there's a lot of little details that can be worked out. You're going to have to find a way to ensure that the safety net for people who are outside the workforce whose investments are particularly low. There are a couple of ways you can do this. One way is called a “floor benefit.” Floor benefit simply says we'll going to take everybody in America and we're going to decide on average we're going to have to give them about $300 a month, or whatever, so we mail everyone a check. Congress likes that, in general, because it's easy to budget. They know how many people are over 65, they multiply by $300 a month, and they come out with a number. It's easy to fit into the budget calculations. The disadvantage of that, of course, is it means you're sending Ross Perot a $300 a month check and why do you need to do that?

The other way to handle this is what I call a "minimum benefit," and I liken that to sort of topping off the tank. What that says is that at retirement, we look at how much you would need in your account to purchase an annuity that would bring you up to whatever we've decided is the minimum level of retirement benefits that you should be at, and the government's role is to come in and to take — if you need to be here and you're here, the government merely fills in that gap. Now the advantage to that is it's strictly a means tested program, it's strictly according to the people who need it. The disadvantage is you can't budget it until you've seen how people have done and how the market has done and things like that at the end of the year, and it leaves you with a contingent liability which is very hard to bud-
get. So that's why it's in some disfavor among some places in Washington, but I think it's a much better way to go.

Either way, what you're going to be doing is getting away from a massive middle class transfer payment and transforming that portion of Social Security designed to redistribute wealth into a welfare program that should be funded — out of general revenues, not out of the payroll tax.

You're going to hear about the Social Security Advisory Council which has got a proposal that allows half of your Social Security money to be put into private accounts, and continues the other half simply to provide a floor benefit. The reason they got trapped into this was that once they decided to have a floor benefit, they said it would have to be funded out of the payroll tax, so they continue taking part of the payroll tax to fund the floor benefit, which reduces the amount that can be privately invested, which reduces the return, which means that the floor benefit has to be higher, and they get themselves into this cycle. I want to stress that the payroll tax needs to be gotten out of there completely and you should have that portion of the money be privately invested. And if you're going to have a welfare function, it should be treated like a welfare program, or any redistribution program, and funded out of general revenues.

If we move to this type of system, we can create a system in which today's young people will be able to retire with the same dignity as today's seniors. We can ensure that no one is left behind. We can create a huge new pool of capital — and I think Dr. Hall is going to talk a little bit about this in terms of national savings, what this is going to mean when you move $300-400 billion a year into private capital markets. You're going to create a system in which everyone is a winner, instead of a system that is guaranteed to make almost everyone below the age of 50 out there a loser.

Respondent: Dr. Arthur P. Hall, Senior Economist, Tax Foundation

What I'd like to do is expand a little on some of the rates of return points that Mr. Tanner made. And I will cover some of the same issues, but put a slightly different context on them.

First I'd like to start out by saying in 1982, the last time Social Security faced impending bankruptcy, Newt Gingrich said this, and I quote: "As a first principle, no discussion of change in Social Security can get anywhere in a free society until it first reassures everyone in the society that the survival, safety, and peace of mind of the elderly are paramount. You can't tell the least mobile people in this society that we're going to change the rules of the game at the end of their life. That would be fundamentally wrong. You cannot build a decent self-governing free society when you break faith with your grandparents." Now, I think that statement is as true today as it was back in 1982. But it only tells half the story. The other half of the story is the massive financial burden that grandchildren must bear so as not to break faith with their grandparents. Now grandchildren want to honor the tacit commitments they've made to their grandparents. On the other hand, I think it's fair to say, the grandparents don't want to burden their grandchildren, or their children for that matter. And it's this mutual regard, combined with a thorough education about the predicament that each generation faces, that holds the key to reaching a constructive political compromise on this very, very tangled-up issue.

Now, the electorate must know — and this cannot be emphasized enough — the electorate must know that the Social Security system, that is the federal government, has sown the seeds of inter-generational conflict. Grandparents may become a rival political faction against their grandchildren because of the perpetuation of a myth, the myth of the Social Security Trust Fund. It's exposing this myth that offers the best hope for assuring that genuine Social Security re-
form has a future. Few people seem to understand that the so-called "Social Security Trust Fund" is a complete fiction, which is what Mr. Tanner explained. The federal government has saved no one's Social Security contributions. What is habitually called a "Trust Fund" is primarily a conduit through which payroll taxes are collected from American workers and their employers and immediately distributed to Social Security recipients. Understanding this fact is crucial to understanding both the political popularity of Social Security and the monumental fiscal policy problem that it poses.

In the lead-up to the discussion on the rates of return, it is important to understand that Social Security benefits have never been strictly tied to what someone has paid in payroll taxes. Benefits are determined by formula, a formula based on wage histories. As a result of this formula, Social Security provided people retiring before the early 1980s with huge real rates of return on their employer-employee payroll taxes. These people generally received benefits based on their highest lifetime wage levels, but paid relatively low lifetime payroll tax rates. The resulting high rates of return is what makes Social Security so politically popular, or at least in part. But the days of making a killing on Social Security are gone. We've entered the phase of Social Security's history in which the bulk of people paying into the system can expect sorry investment returns. And the sorry returns become even worse if policymakers and the electorate focus only on repairing the solvency of the Social Security system.

You see on the first chart I have rate of return on Social Security for low-wage couples. These are hypothetical couples, and on the y axis you see the rates of return, and on the x axis you see this hypothetical low-wage couple's age next year, 1997. I chose low-wage couples for an obvious reason. These are the people that the proponents of perpetuating the current system are going to hold up as the reason we need to keep the current system going. The pattern of returns you see here is identical if you have an average wage couple or a high wage couple. The only difference is the rates of return are worse, and the negative rates of return come sooner in time. Now notice, please, the extremely high rate of return of someone who would be hypothetically 80 in 1997. That person or that couple would have retired in 1982. Then you notice the steep decline through time. It goes negative through the baby boom years, and then at current payroll tax rates, it turns positive again for future generations. It turns positive again because of the assumption of longer life expectancies, real wage growth combined with a flat tax rate. But, we know that the Social Security system is not sustainable under the current structure of benefit payments and payroll tax rates.

So I've conducted an experiment. I raised the payroll tax sufficiently to make Social Security solvent. And as you can see, the rates of return for a low-wage couple turn negative forever more after the baby boom generation, or beginning with the baby boom generation and going through the baby boom generation. And I think it's very important to point out that any reform you make that has solvency as the sole criteria for reform is going to have a similar result. Whether it's increasing the retirement age, reducing benefits, taxing benefits, it all in one way or another has the effect of making Social Security benefits cost more. Therefore, the rate of return is going to drop.

I want to hone in on the baby boom generation, which is marked out there on the bottom of the chart. Look at how badly low-income couples of the baby boom generation far under Social Security. And as lifetime wages grow, the rates of return grow even worse. I think it's because of these dismal rates of return that the baby boom generation is not only the cause of the coming fiscal problem, but it is also the source of the political promise of true Social Security reform. The reason is that, even though their huge numbers are what's going to cause the insolvency, baby boomers and their kids stand the most to lose from traditional fixes, whether that's payroll tax in-
creases, benefit reductions, increasing eligible ages, or taxing benefits.

Mr. Tanner didn’t get into it too much, but I think that to the extent that we have seen people deal with this problem around the world, a Chilean style opt-out program seems to be the best way to deal with the conflicting problem of negative rates of return and insolvency. By allowing people to opt out and invest in real income-producing assets, the federal government can simultaneously reduce its future liabilities and therefore deal with the solvency problem, and also improve the financial position of most future retirees.

I’d like to give you an intuition about the opt-out program in America. We know, in the case of Chile, that about 90% of the covered workforce chose to opt out of the government-run social security system. So to give you an intuition about who might opt out in America, I’ve tried to perform a little experiment and ask the question if given the choice next year, 1997, who in America would opt out. You see from the table this is the maximum age in which a couple would opt out if given the choice, and I have three different wage profiles here. And I’ve devised two opt-out strategies. The first strategy is the “cold turkey opt-out.” Then we have the “Chilean style opt-out,” and I’ll explain a little more in detail how the Chilean program works to give you some preparation for the discussion later today.

The “cold turkey opt-out” simply gives people a choice: You can forfeit all of your Social Security benefits and forget about all the payroll taxes you’ve paid in your lifetime, but the moment you take that deal, you’re exempt from the payroll tax. However, I do assume that the person who chose to opt out would continue to save the same amount each year that they would have paid in employer-employee payroll taxes. Under that scenario, a low-wage couple 25 years or under would just say, “Okay, I’m leaving; get me out.” The same is true for an average-wage couple 32 or younger and a high-wage couple 37 or younger.

The ages are much higher for the “Chilean style opt-out” because we recognize past payroll taxes paid under that scenario. In other words, we acknowledge that everyone is vested in the system because of their past payroll taxes. I’m not doing exactly what Chile did in dealing with that vestment, but it’s very close. The way I do that is I say, okay, upon the opt-out decision, the government is going to give everyone a bond equal in value to their inflation-adjusted lifetime payroll taxes paid, both employer and employee portion. And those bonds are going to mature at age 65 and they’re going to rate a return of interest equal to what the Social Security Administration earns on its special issue bonds. After opt-out, people are assumed to save, once again, everything they would have paid in payroll taxes. And that grows, I’ve assumed, at the same rate of return that a portfolio of an equally weighted AAA, AA and A bonds would return over the same time period. So under that scenario, you bump up the age to 37 for a low-wage couple; anybody 37 and younger would walk. Anyone 48 and younger for average wage would walk. And anyone 54 and younger would walk if you’re a high-wage couple.

Now two other peripheral things we can see from this. You can see the correlation between lifetime wage levels and ages. That’s just one more way of representing what a sorry investment Social Security actually is. And it also shows the redistributive element, the income redistribution element of the Social Security program.

Now I’d like to point out one major caveat to my experiment, and that is I’ve ignored the important issue of financing the transition to an opt-out plan. And any financing arrangement is going to influence people’s decision whether to opt out or not. It’s not going to be as clean as I’ve made it. And financing a transition, I think, is going to be required politically. After all, continued funding of existing liabilities is how we keep faith with our parents and grandparents, because not everybody, as you see, is going to choose to opt out.
In the next chart I'd like to show you briefly what a Chilean plan might look like and how and why — where I get these numbers from in the first place about the ages. I'm trying to do a lot with this chart; it's kind of busy, so I'll go through it somewhat systematically. This chart shows for hypothetical average-wage baby boom couples, their expected Social Security benefits based on current law — and I should mention these are all after-tax Social Security benefits, after-tax annuities — the y axis shows the dollar amount of either Social Security or a total opt-out annuity that you could purchase if you chose to opt out in 1997, and again the x axis shows people's age next year in 1997.

The black line in the chart represents Social Security; the other line represents the opt-out annuity you could buy, the cash flow investment that you could purchase from the proceeds that you acquire, either from saving or your recognition bond. And I want to point out there are two parts to the opt-out, there are two different cash flows, but there's a total annuity. One part of the annuity stream comes from your recognition bond: You are given the bond, it matured at the time you retired, now you can buy an annuity with it. The other part, the white part, is from your private savings. So you can see that time is really a critical factor in the whole idea of implementing an opt-out plan. The sooner you do it, the better off taxpayers can be. And as I showed in the chart prior, people 49 or older, using this hypothetical wage couple, wouldn't take the deal. Opt-out doesn't start getting better until age 48 or younger. So, again, time is a critical factor. The sooner you do it, the better off taxpayers are. And I use the word "taxpayers" for two reasons: First, and most obvious, is that taxpayers are Social Security recipients being forced into a bad deal. Second, you can compare the federal government's liability under an opt-out annuity versus the present system if you take a look at these charts. The Social Security line represents the federal government's liability under the current system, that is, the payments per retiree per year, so it's on an annualized basis. The annuity that comes from the recognition bond, the shaded portion of the opt-out annuity, gives you some feel, it basically approximates what the government's liability would be under an opt-out program. So by comparing the black line with the shaded portion of the white line you can see that an opt-out annuity or an opt-out program allows people not only to be much better off in their retirement, but it also dramatically reduces the federal government's liability. That's the solvency problem that you can deal with. That's the portion that actually has to be funded, but it's much lower.

So I think as the chart shows, an opt-out program, somewhat akin to what Chile did, would be good for taxpayers, and I think the chart also shows that Social Security is a poor retirement program. And it may be true that in times past that Social Security responded to our economic security needs. But today and in the future Social Security is shaping and even creating those needs. In fact, it's my opinion that Social Security is exacerbating the needs that it's supposed to repair.

Social Security is a huge, complex and firmly entrenched institution. But it's going to have to be changed. And how it will be changed is our opportunity. The opt-out solution holds the promise of improving the standard of living for us and our posterity without necessitating that we break faith with our grandparents.

**Presentation 2: Learning From Chile**

"An Overview of the Chilean Reform Experience"

Presenter: Dr. Ricardo Zabala, Citibank, NA., Santiago, Chile

Even though I'm a native Chilean, and I'm very proud of the system we've installed. I'm basically going to talk about the Latin
America experience, what we have done in Latin America with this issue. And to put it in context, what I’ve tried to do is to set a conceptual framework so we can understand what was done in Chile, and what has been done in the rest of Latin America.

Today, Chile is the only country in Latin America that has a well-operating private pension system. Peru started following the Chilean experience in 1993, Colombia and Argentina in 1994, Uruguay in 1996. Mexico’s system is going to start operating in January of next year, and Bolivia is starting in 1997 also.

Now, when we look at Chile, the system looks very appealing. There are 15 pension fund management companies. I’ll explain later what they do. There are $27.3 billion of assets under management, 53% of GDP. There are 5.2 million workers in the system. The population of Chile is approximately 14 million, so this is 87% of the labor force. It has a very young system; it started in 1981. It has only 216,000 pensioners. It has also a million additional savings accounts. The average rate of return between 1981, when it started, and 1994 is 12.7% over inflation. Even though in 1995 the real rate of return of the system overall was 2% under inflation. There are higher pensions than the old system. This relation that Mr. Hall was making between the pensions in the pay-as-you-go system and the private system, they are higher. And there’s been the development of a very dynamic capital market. Chile has the highest savings rate of Latin America, 28% of GDP. And it covers disability and death and therefore it has a very strong insurance industry.

The Chilean experience, basically, is social security reform to grant decent pensions. In 1992 in Mexico, they did a reform which was to increment the savings rate. When people look at Chile, one of the things that really attracted them was the fact that you had created a high savings rate. But when you only look at the savings rate and you don’t look at the issue of social security or the pensions you’re going to give out, this has different implications for how the system is set up. When you look at the nature of a pension system, they basically depend on three things:

• The financing scheme: You can have a capitalization scheme or a pay-as-you-go, and you can have combinations of both.

• The benefit structures: You have defined benefit schemes that are these entitlements, basically where you reach some certain age and you’ve worked some certain number of years and you reach a defined benefit. Or you have a defined contribution, where the benefits are not defined, but the contributions you put into the system are defined.

• And the management scheme: You have basically a centralized or a non-competitive system where a centralized system does it like the U.S. Social Security system; a decentralized system which is competitive; and you can have a specialized or an integrated system. Basically when we talk about specialized, it means contribution for disability, another contribution for old age, another contribution for health, and operating three different schemes. An integrated system is one where with one contribution you cover all these contingencies.

So with that set out, basically in the traditional systems, most of the financing scheme is a pay-as-you-go system; it’s just a distribution system. The benefits are defined nominally, so they’re eaten up by inflation. And the management normally is done by the government — centralized. And in the “modern systems” you have capitalization schemes, you have benefits that are defined or variable, and basically the management is private.

The Chilean solution is it chose a capitalization scheme in individual accounts. You can have collective accounts, employer-driven accounts, but this is individual accounts. It’s a pre-defined contribution system. It substitutes the pay-as-you-go option. It’s a specialized private management. And basically it’s a public social security system privately managed. And I’d like to insist on this. A lot of people talk about “privatizing Social Security.” You cannot privatize what
is not privatizable. Social Security is a public system. What you can privatize is the management, or how the system is dealt with.

Basically how it works is you have individual accounts managed by sole purpose private companies. These are sole purpose private companies; they cannot do anything else but manage the accounts for their clients. The pensions are a function of the accumulated fund. Whatever you have accumulated is what you receive as a pension. There is disability and death coverage. The pension ages are 65 for males and 60 for females. Early retirement is possible if you have accumulated in your account enough assets to give you a pension which is at least 50% of the last 5-year average of your working years, you can retire early. There’s a government guarantee. Michael Tanner mentioned the minimum rate of return. There’s also a minimum pension. If you’ve contributed into one of these companies during 20 years, if the accumulated fund does not give you a pension as large as the minimum pension, the government guarantees the differential.

There’s a minimum rate of return for each managing company, which is an average of the industry. So, for example, I mentioned that in 1995 the average rate of return was 2% negative. The average rate of return — the minimum rate of return was also negative. But you could be way off the negative, or you could be lower than the minimum or higher.

Fees are charged as a percentage of the wage or contributions. The management fees are not based on assets under management. This is really not an asset under management industry. It’s related to assets under management because it manages them, but the fees are not related to the assets. One of the reasons legislators chose that is because since it was mandatory, what happens to a worker when he’s unemployed? He’s not contributing into the system. His assets are being eaten up. So, basically, the workers that are working are financing the accounts of those workers that are not working. And during the transition in Chile—and this is the same situation in Peru and Colombia—the government recognized the contributions to the old system. Like Dr. Hall mentioned, this is a bond that’s redeemable when the workers reach retirement age. And to move into the system, the contribution rate was reduced. So this is cheaper than the old pay-as-you-go system.

But what do these companies really do? These companies manage individual accounts, and this is a processing business, basically bookkeeping, administrative services. They give insurance coverage for disability and death, and they do investment management. But with only one fee. There’s no fee for administrative services, there’s no individual fee for insurance coverage, there’s no individual fee for investment management. It’s one fee for the whole package.

And basically the way it works is something like this: You have the clients make contributions. And the contributions are a percentage of the wage bill, or the payroll, into the pension fund, and fees once they’re accredited into each individual account, you can charge a fee. You don’t know who the money comes from, you can manage the assets, but you can’t charge the fees. And the fees are a percentage of the wage bill or a fixed fee — $1 per contribution or whatever. They go into the management company and the management company hires a collective insurance with an insurance company to give disability and death coverage to the workers that are in his company. And at the same time, since it has a minimum rate of return guarantee, it builds a legal reserve, which in the case of Chile is 1% of the funds under management. So it manages individual accounts, it does the investment management, and it gives through here the disability and death.

So during the active life every worker chooses — has to choose — one pension fund management company. In the transition, at the first moment, like Dr. Hall mentioned, you could decide to stay in the old system — and there’s workers who stayed — or to move into the new system. It’s true
that mathematically there were ages in which the decision was better to stay in the old system because you were too old, or to move into the new system. There's something that's really important here, and I think it's good to mention is that this is your money. This is not the black hole of the pay-as-you-go system. This is an individual account that belongs to you and to your estate, in the case of your death. So basically there's not only a mathematical or technical reason to enter this, but basically there's a conceptual difference. This reform has shifted the power to the people to take the decisions where they want to put their money.

So during their active life, there is a pension fund managed by a pension fund management company, and once they attain eligibility, they can choose a program withdrawal pension in the same pension fund management company, which is basically they start eating their capital. Or an annuity pension in a life insurance company. That's why I mentioned one of the first slides how many life insurance companies there are. The overall size of the pension fund is approximately $27 billion, and the investment portfolio of the life insurance company is approximately $7 billion. The clients channel the funds into the company, the fees go into the pension fund management company, and in an average month about $200 million go into the fund, about $50 million go in fees, $1.5 million go into the legal reserve, about $13 million go into the premiums. So you have a legal reserve that's about $250 million and a pension fund that's $27 billion. In a country where the GDP is around $67 billion, this is a very large percentage of the GDP.

That's why I mentioned the issue. This is a sole purpose company. They have an operating structure that could provide some of these services, but they cannot do that. So basically the model that started in Chile is a self-contained industry whose activities could be done by other industries, which could be relevant in the case of a reform in the United States.

Now what's happened in Latin America is that most countries are optimizing between their present pay-as-you-go system and Chile's reform and what I would call an "unbundled solution." An unbundled solution is where parts of this self-contained industry are given to different parties. You're moving from a pay-as-you-go system to a pure capitalization scheme. Now the issue is always who pays the transition costs. What we believe is happening in Latin America, the way they're approaching this industry, is basically that these systems will be unbundled in the long term. And basically it makes sense in countries where you do not have very competitive or deep capital markets, or competitive asset management industries, where you don't have competitive life insurance industries, and you don't have competitive industries in the area of processing, that you would do it contained. But if you have the alternative of unbundling them, you can make better or more efficient decisions.

Now I'm going to run these very quickly just to show you that when you look at the set-up of Peru, it's similar. The only difference is that you do not hire a life insurance company for the management company, but you were just a retainer for the premium the worker pays for the life insurance company he chose. So you have an alternative to choose the asset manager and to choose a life insurance company. But conceptually it's the same.

Colombia, they had mixed feelings when they started the reform. What they did is, they revamped their old pay-as-you-go system to compete with this new system. So you have now a pay-as-you-go system managed by the government competing with this private system. But it's quickly losing the war.

In Argentina, this is the largest market today. The population of Argentina is approximately 28 million. It's the same set-up, but they have a centralized regulating system that's reduced the regulation and the operating costs.

In Mexico, they did the same thing, but
as I mentioned, the unbundled part, the insurance coverage is given by a whole other industry. It's a mandatory system managed by the government. So basically it's something like this: You only have the processing and the asset managing. You have no insurance intermediation at all.

If in every one of these countries you had to choose between a pay-as-you-go option and a capitalization scheme, except Mexico and Bolivia, which you have no choice, you can just choose an operating company. In all of them you have an individual decision, it's an individual choice, so this is like a retail business, it's high operating marketing and sales costs. Fees over assets under management can only be charged in Peru, Mexico and Bolivia. In Peru nobody charges all those assets under management. One of the reasons is there's not many assets — the growth of the assets takes a long time to grow. There's a disability and death coverage; every country has one except Mexico. There are state or public competitors in most countries, otherwise in Chile or Peru you have some state-run operation that competes with the system.

The impact this has had on Chile's capital markets, is basically: 51% of all government securities are in the portfolio of the AFPs; likewise with 63% of all mortgage bonds. So the financier of all housing industry is one of the AFPs. They have 8% of CDs, more than 50% of all corporate bonds. Only 9% of the stocks; one of the reasons is because not all the companies are rated. It's a very regulated industry, so there's a lot of rating issues to what you can invest in.

This has really reshaped the capital market structure in a sense, such that in 1995 35% of all the assets and liabilities were in the hands of the pension funds. Now what's most important is not the stock but the flow of funds. In Argentina, the monthly contribution into the fund and the fixed rate portfolio is Argentina $120 million. That's about 4 basis points of GDP. In the fixed rate portfolio, since the high percentage of the portfolio is in fixed rate, and it's redeemed and it matures, about 12% goes into the GDP. Total year, 1.6%. So this is net impact in the capital markets of new money that's going into the market. If you look at the case of Chile, $150 million per month, which is 0.3% of GDP, the fixed rate portfolio part is $4.7 billion, which is 9%. Overall, on a yearly basis, that's 12.7%. That is basically one of the reasons Chile has one of the highest savings rates of the region.

Respondent: Dr. John Goodman, President, National Center for Policy Analysis

I want to respond not just to Ricardo Zabala's presentation, but also, if I may, to the other presentations we've heard so far today. And I'd like to begin by making five quick points. Point number one, pay-as-you-go really means pay-as-you-go. The system in the United States, as opposed to these systems that we just saw the slides on, is a system in which every dollar that is collected in payroll taxes is spent, and it's spent the very minute, the very hour, the very day that it comes in the day. No money is being stashed away in bank vaults; no investments are being made in real assets. This is an important point, because I think when we start talking about when the system is going to go bankrupt and how much is in the Trust Funds and how much is not in the Trust Funds, we tend to mislead people. We tend to encourage them to think of this like a private pension system, and we use the language of actuaries, when in fact the Trust Funds have no real meaning, they consist of nothing more than IOUs which the government has written to itself, they consist of nothing more than pieces of paper. If those pieces of paper were important, if somehow they could solve our problem, then it would be easy to solve the crisis of Social Security: We could just print more pieces of paper. The federal government could very easily double, triple, and quadruple the number of pieces of paper these Trust Funds are holding. That would be easy; that would be cheap. But since the paper
doesn't mean anything, it would solve no real problem. If we look out to the future in a year, say 2030, and we see what the obligation is, in that year we're going to have to borrow money or raise taxes to meet it. And the Trust funds are not going to help us either borrow or tax.

Number two, so far everything that we've heard has been about Social Security and we've heard nothing about Medicare, but I want to remind you that the same payroll tax that funds Social Security also funds Medicare. And if you go out to the time when today's college students are going to reach their retirement years, according to the intermediate forecast, the Medicare obligation for both parts of Medicare is going to be as large as the Social Security obligation. And on the pessimistic forecast, it's going to be even larger. In fact, for every dollar that we spend on Social Security, we'll spend $1.50 on Medicare on the pessimistic forecast, in the year 2040, about the time when today's college students will reach their retirement age.

Point number three, that other health care costs disguised and hidden in other programs are half again as large as Medicare. In general, for every dollar that the federal government spends on Medicare, it spends another 50 cents on elderly medical bills through the VA system, Medicaid, and other programs that are set up. If we combine the Medicare — both parts of Medicare — plus these other ways of paying the medical bills of the elderly, the forecasts begin to get really scary. On the intermediate forecast, by the time today's college students reach the retirement age, we're going to need 40% of payroll, and on the pessimistic forecast, we're going to need 67% of payroll — that's two-thirds of all the income of future workers — just to pay elderly entitlements.

Point number four, tax rates do not equal tax revenues. The Social Security trustees are kind enough to make all these projections for us. They tell us what percent of payroll we're going to need in various years in the future in order to meet the obligations that have currently been written into law. So they say, you're going to need 30% of payroll, or 40%, or 50%. What they don't tell us is that if you need 40% of payroll, you're not going to get it simply by levying a 40% tax. You will recall that when Bob Dole was defending his tax program, he argued that when you cut tax rates, you get some of it back. You get some of it back because at lower tax rates you have less avoidance, less evasion, more economic activity, higher growth. In fact, he argued, you can get 30% of it back just through greater economic activity. Well, presumably that works in reverse. If you have a substantial increase in tax rates, you're going to lose about 30% of it through more avoidance, more evasion, less economic activity, lower economic growth. And if we just use that standard that you lose about a third, then you can up all the Social Security Administration's projected tax rates by a third. And on the intermediate estimate, then, we're going to need a 50% tax rate when we get out to the time when today's college students retire. And on the pessimistic forecast, we're going to need an 85% tax rate when they reach 65; when they reach 85, we're going to need a 97% tax rate; and when they get to the age of 95, if they live that long, we're going to need a 105% tax rate — in other words, we're going to need everything that workers earn plus some change in addition to that. But as Art Laffer taught us a long time ago, when you get out to 100% tax rate, you really don't collect very much revenue.

Point number five, all our entitlements are pay-as-you-go, it's not just Social Security, it's not just Medicare. All of them. The Medicaid, all the government pension funds for public employees, they're all pay-as-you-go.

I think that an ideal retirement system is a system that, first of all, should be able to survive any choice that women make about how many children to have. Our Social Security Administration considers it a real crisis that women aren't having enough
babies. The fertility rate in the United States is below the replacement rate, and in some European countries, it's way below the replacement rate. It's only 1.3 children per woman of child-bearing age in Italy, which is a Catholic country. It's 1.4 in Germany. And they've got real, real problems. But a good retirement system should be a retirement system that can live with any choice that women make.

Also, a good retirement system, I would think, is a system that can live with any choice you make about immigration. We are, as we move further and further along the path that we're now traveling, going to feel a lot of pressure to admit lots of immigrants in order to keep the tax rate down, in order to have lots of taxpayers to support the elderly. But we ought to be able, as a country, to decide on an immigration policy without worrying about where the elderly pensions are going to come from.

Number three, I think that an ideal retirement system is one that can survive any breakthrough in medical science. It is shocking to realize that if scientists tomorrow discovered a cure for cancer, most of the nation would be rejoicing. That's not what's shocking. What's shocking is that over at the Social Security Administration they would be totally depressed, because any kind of breakthrough like that is to them totally depressing and represents huge financial liabilities which they don't know how they're going to meet. But with a good retirement system we shouldn't have to worry very much about that.

And finally, a good retirement system, it seems to me, is one in which you don't have to worry very much about the rate of economic growth. In the Chilean system and those other Latin American systems that you were looking at, the pension that the worker retires on is going to bear a rough resemblance to the state of the economy. In other words, their pension income is going to grow with the rate of growth of the economy as a whole. If for some reason in the United States we decided we didn't want to grow quite as fast because we want to achieve certain environmental goals — I'm not suggesting we should do that — but those are the kinds of decisions we should be able to make and not have to worry about how elderly pensions are going to be paid for.

All of this means, in my opinion, that a good retirement system is one which is not pay-as-you-go. It's one in which each generation pays its own way, puts the funding aside so that it does not have to depend upon the next generation of taxpayers to pay his retirement benefits. And there are countries around the world which have made substantial movement in the direction of ideal pension systems. And we just learned from Ricardo that in addition to Chile, we also have Argentina and Colombia and Peru and now this year Mexico.

But there's another country that I think should be interesting to all of you and that is Britain. Britain began to tackle this problem back in the 1970s. Britain should be of interest to you because their culture is more similar to ours, they have a political system which is not that different from our own. It's a democracy after all. They didn't have to have a General Pinochet in order to introduce privatization. But they realized they had a problem. And interestingly enough, both parties, the Conservative and Labour Party, came together in a joint agreement that they needed a private pension system to take up part of the load rather than having all of it funded through a pay-as-you-go public pension system. And so they began allowing employers to contract their workers out of the second tier of the government social security system. The first tier provides a minimum payment; essentially everyone gets the same check. The second tier is related to earnings; the more you put in the more you get. That second tier is more like a private pension, and it's that second tier that employers could contract their workers out of.

So beginning in the mid-1970s, employers began to do that, and by the time Margaret Thacher became Prime Minister, almost half of all British workers had been
contracted out of the second tier social security in exactly that way. But the problem was that in order to do this, a company had to promise pension benefits at least as good as the worker would have received had he remained in the state pension scheme, and essentially only large companies could do that and therefore about half of all British workers were the limit that were going to get contracted out in that way. So Margaret Thatcher's contribution to this was to allow individual contracting out. And during her term of office, Britain went further and now they allow individuals not only to contract out of the state pension scheme, but also to contract out of their own employer's contracted-out scheme. So this powers the individual, gives them the ability to deposit funds to U.S.-type IRA accounts. Unlike the Chilean experience, they can make almost any investment decision they want to through these IRA accounts. I'm not sure that that's desirable, in the sense it won't at the end of the road necessarily accomplish the social goal of insuring that a pool of retirement funds is there. But in any event, that's the way they do it. And today, either through an employer plan or through their own IRA account, three-quarters of all British workers have contracted out.

Essentially Britain has followed three principles that you also saw present in Chile and in these other Latin American countries. Number one, they make the decision voluntary, people don't have to go into the private system, it's a voluntary decision. But number two, they create a choice, there's a public system and there's a private system. And number three, they make the private option so attractive that in fact most young workers are looking at an option they cannot turn down. So you create differential tax rates. In Britain right now, the difference between opting out and staying in is about 4.8 percentage points of payroll tax. In the beginning it was 7 percentage points. You need to have it larger in the beginning because you need to get middle-age workers out. To just get younger workers to join the private system you might need much less of a difference.

Finally, another country I want to draw your attention to is Singapore. During the 1980s, countries from around the world were going to Britain to learn about privatization. During the 1990s, more and more countries are sending delegations to Singapore to learn about a really fascinating alternative to the welfare state. It is almost as though Singapore looked around the world, especially at the developed world, and looked at all of the ways in which the welfare state has grown, why people go to government, what kind of benefits they're looking for, and they created a private savings alternative to all of that. And I must tell you the savings rates in Singapore are quite high. They require the worker to put in 20%, the employer has to match that, so that's 40% of income that's being saved. And as a consequence, Singapore has the highest savings rate in the whole world. Now out of this forced savings, people have their retirement pension, as they would in Chile and some of these other countries, but they also have much more. Singapore has what they call a "Medisave Account," which is equivalent to the medical savings account that we have promoted here in the United States. Essentially they're required to put 6 percentage points of income into the Medisave Account. Out of the Medisave Account they can buy catastrophic health insurance coverage and pay many medical bills. They can also take money out of their forced private savings in order to buy housing, and Singapore has the highest rate of home ownership in the entire world. They can use these funds to buy life insurance, disability insurance. They can pay medical bills of another family member. They can borrow from their forced savings in order to send a child to college. And the way this has progressed is it began in the 1950s as a pension program, and then in the 1980s they added on the medical care component of this, and then as they moved along they started adding more and more features as they began to realize that a system of forced private savings can in fact meet a lot of the
needs that are met by government elsewhere. And so what Singapore has today is a very successful system. It’s a system that people are very, very happy with. The principal drawback, I would say, is that government has too much control over the money. In the beginning it had total control over the money and made all the investment decisions. With the passage of time, it began to allow individuals to make some decisions with a portion of their money. So this isn’t like Chile. It should be like Chile. There’s no reason to have government in there directing the investment of these funds. But aside from that, the structure of the Singapore system, the idea that people are required to meet their own needs rather than going to government is, I think, a good idea and one that we might carefully consider as we dismantle the welfare state in the United States.

In general, the philosophy of Singapore is very simple: It’s that each generation should pay its own way, each family should pay its own way, each individual should pay his own way, and only after you go through those three filters, then and only then does anyone turn to government. A good lesson, I think, for us to follow here in the United States.

Presentation 3: Options for Reform

“An In-Depth Discussion of the Choices that Must be Made in Crafting Reform Legislation”

Presenter: Stephen J. Entin, Resident Scholar, Institute for Research on the Economics of Taxation

Patching up the system with a mix of tax increases and benefit cuts might solve the petty little budget problem, from the point of view of a budget policy wonk in Washington, but at too high a cost to the economy and everyone in it. Keeping the current system would require benefit cuts or tax increases that would make Social Security an absolutely horrible deal for future generations. Reform must do more than fix the budget. Reform should not just be driven or even primarily be driven by budget considerations, nor for the convenience of Washington policy officials. We need to do something to redress the damage that Social Security is currently doing to national saving and to employment.

The issue is one of a choice — and we’re getting to our first choice — between a tax transfer system and a system of real saving. A pay-as-you-go tax transfer system can never be as good as a system with real saving. When Social Security takes a dollar of payroll tax from current workers, it pays out a dollar of benefits to current retirees, and they generally consume it. There’s no saving involved. Indeed, total saving is likely to decrease. By contrast, workers who set aside income in bank accounts, mutual funds, stocks and bonds are saving that income. The saving flows into capital formation which boosts productive capacity and earnings and wages and employment. The compound returns on that saving and on that real capital formation produced several dollars at retirement for every dollar of contribution. Instead of one dollar in and one dollar out, you get a much better return. At a 7% real return, a dollar saved at age 20 would grow to $16 at age 60 and to $32 at age 70. No tax transfer system can give that kind of gain.

Now, the Kerrey-Danforth Commission seized on these advantages of real saving to suggest a way out of the Social Security bind. This is another chart from the Commission’s report. Kerrey and Danforth suggested that we not raise taxes to bring Social Security into balance. They opted instead to trim Social Security benefits by even more than was needed over time to keep the system in balance. They then suggested that the added spending cuts, more than necessary to keep the system in balance, would allow a 1.5% payroll tax reduction that workers would be required to save. And they assumed a fairly low return on that IRA saving. The saving would generate more re-
retirement income than the added benefit cut, which would make the worker better off, offsetting some of the pain of bringing the system into balance. They would cut the projected outlays so that the unfunded promises would be eliminated. They would cut benefits to the level that could be sustained by current taxes, then they would cut benefits on the right-hand by a little more, but you put that difference into an IRA and the added returns from the IRA would bring you back above what Social Security could otherwise pay for.

But if cutting benefits and the payroll tax 1.5% puts workers ahead, why not 2%? Why not 5%? Why not 10%? Be careful what you prove. Someone may want you to deliver on your proof. In fact, why not phase out the system altogether? But I'm getting a little bit ahead of myself.

A number of proposals that have been floated since this Commission have sort of built on this idea. In fact, almost everybody who comes up with a proposal to bail out Social Security pays lip service in one way or another to using the private markets either for Trust Fund investment or by giving people control over their own savings, but the buzzword now is "private sector markets," using the free markets to do some good for the transition to a new system. But some of them are much better at delivering on the concept of privatization than others and for some it really is just a buzzword. Now which of these notions and approaches we need to look at to solve this problem brings us to a whole mess of choices, and I've tried to group them by their general issue area, not by whose bill they're in. So I'm going to go issue by issue, not bill by bill.

Once you have decided that some sort of funded system is better than pay-as-you-go, you have really two basic large issue areas that you need to think about. I'm going to call one "the destination." What should the retirement income system ultimately look like when we get there? The other set of issues involves the transition. How do we get from here to there with the least possible harm to the economy, to workers, and to retirees? We have a lot of choices to make.

Let's look initially at the destination, that is, the basic design of the retirement system. There are two broad choice areas. First, should the government run the show, or should the system be based on self-reliance, personal responsibility and private saving in the private financial markets? A clear set of choices that need to be made. Another set of choices in designing the system is the question of whether the welfare or safety net elements of the current Social Security system should be wrapped up in the new retirement system or handled separately. Social Security, as you know, tries to do two things, provide for retirement and handle income redistribution and safety net considerations.

Let's look at the first issue, which is the broad heading "Government Control Versus Privatization." Let's see what this involves. One of the first things you might ask is: Should saving for retirement be voluntary or mandatory? The approach most consistent with economic freedom and personal responsibility is to make saving optional. If the tax biases against saving were eliminated, which most of the major tax reform proposals would seek to do, which is a whole other conference, people could decide in an optimal manner how much income they want in their old age and when they want to retire, and they would save accordingly. Congress, however, is fearful that people would be spendthrift in their youth and rely on the dole in old age and Congress seems determined to regulate saving behavior. So I'm going to assume in what follows, reluctantly, that some saving is made mandatory.

We come to the next choice. In setting up a retirement system with all the federal rules that will be attached to it, we need to ask: Who is going to control the assets? Will the assets be controlled by the government or by individuals? Even if you move to a funded system, and the private personal savings account is obviously automatically
funded, but a funded system does not necessarily mean personal control. Some people think that a funded system can be run by the government. Others prefer that the individuals do it. You're going to see a full range of views on this in the forthcoming report of the Advisory Council on Social Security. They're going to be coming out with three plans which rather run the spectrum of possibilities. They all pay lip service to privatization, but one of those plans does more of it than the others. But in anticipating one of their proposals, let me make one thing clear. Funding the retirement income system and privatizing the retirement savings system are not the same thing. "Privatization" means that each individual saves for his or her own account. The saver owns the account, manages the account, and can leave it to heirs and survivors. One of the proposals coming out of the Advisory Council, one of the old guard which they call "maintenance benefits," would simply take the current Social Security Trust Fund and dump a large chunk of it into the stock market. They call that "privatization," or "using the private markets." But there'd be no separate account for each individual, no individual management of the assets, and no leaving of the assets to one's heirs. Now that's the basic flaw in calling this a "private system." As for the technicalities of it, I don't think I have to point it out to you. The proposal is really quite ludicrous. The Trust Fund is small and fleeting. Furthermore, it isn't really there. The Treasury has already spent that money, so in order to buy stocks, the Treasury would have to issue additional debt to the private market to get the money to give to Trust Fund to buy the stock. That's just like individuals who borrow money and put it into their IRAs and for some reason that makes a lot of anti-IRA Members of Congress really very angry. And yet now we're proposing to do that on a massive scale with the Treasury and the Trust Fund. Social Security would enjoy the dividends and the capital gains, while Treasury would be stuck paying additional interest on the additional debt. This is just another way of getting Treasury to give more general revenue to Social Security and delay its day of reckoning. So that is not perhaps something which ought to advertise itself as a real reform.

But what if there were individual accounts owned in the saver's name and allocable to the saver and to the heirs and survivors. Another plan of the Advisory Council, that produced by the Chairman, Mr. Gramlich, would have individuals have a small amount that they could put into a saving plan, but the government would manage it. It would be in government-managed mutual funds or investment portfolios. Even a federally-managed program with individual accounts, in which individuals were forced to choose among a few federally-run mutual funds, would be dangerous. Why would it be dangerous? The federally-managed funds, including the stock fund, would probably start by being pretty broadly distributed. The stock fund would be an index fund reflecting the U.S. market. However, it would be very dangerous for the U.S. government to be controlling money that could end up being the majority shareholder in U.S. business. The danger is that the stock fund, the index fund, could easily be converted into a vehicle for the government to be selecting stocks favoring one company over another, or one type of investment over another. And to get a good feel for what that might turn out to be, remember all the suggestions of the soon-to-be-departing Secretary of Labor, Robert Reich, about socially-targeted investments.

Now there's another drawback to federal management, and that would be the tendency of federal managers to favor investment in federal debt. In the current Federal Employees' Retirement System, participants may choose a federal bond or money market fund, a mixed asset fund, and a stock index fund. These are described as "low risk," "medium risk," and "high risk," respectively. In fact, as any financial planner will tell you, young workers would be running a considerable risk of losing their comfortable retirement if they invest in the suppos-
edly "low-risk" but low yield government bond fund rather than the "high-risk" but high yield stock fund. Retirement saving accounts should not be managed by government officials. They should be managed, as are IRAs, by workers in their chosen financial institutions or financial advisors. Our reform model should be more like Chile under Jose Pinera and the free market, not Chile under Allende.

Another choice: What can people invest in? If you're going to let them set up these private accounts, what can they invest in? Bonds, stocks, mutual funds, index funds? U.S. only? Global funds? Washington displays an amazing fear of the ups and downs of financial markets, and the prevalence of con artists. I was at a conference just a week ago when one of the Advisory Council members said that everybody would be sold underwater land in Florida. I guess that kind of dated her, but this reveals a great disdain for the intelligence, the moral fiber, and the investment acumen of the average citizen. There is considerable regulation of savers' investment options in most of the reform proposals. Stock-picking is frowned upon; mutual funds are deemed too risky; for stocks, only index funds are allowed and then only those in the U.S. market. I think there may be a smattering of hope that if you force people to buy only U.S. stocks, then all the capital investment will be done here. They forget that most of our major companies are multinational now. In fact, individuals should, within broad limits, be able to invest in a wide range of investment grade assets as custodial accounts, which work just fine for IRAs and 401(k) plans, subject only to modest prudent man rules and perhaps some reasonable diversification restrictions. We often hear that individuals would not know how to pick their own stocks, they wouldn't know how to manage their money. Well, they don't have to. They can hire money managers, they can buy CDs or annuities or mutual funds, or participate in employer-run plans. There are a thousand ways around that objection. And if a global portfolio is deemed to yield greater returns with less risk, the individual should be free to choose it. Fear of the market and its gyrations is overdone. There have been some relatively flat periods for stock prices, such as the 1976-1981 period, but dividends were paid. And Social Security was equally insecure in that period of inflation and poor growth of wages. Remember, it had to be bailed out twice, in 1997 and 1983, both times involving benefit cuts. For my money — and it is my money — in the long haul, the market is the better bet.

Another choice in designing these proposals: How much should be saved? How much are you going to mandate that people save or how much are you going to allow them to save? In the next chart, we see some possibilities. Ideally, the amount that you choose to save would be up to you. If people want to save more and retire earlier, or with a higher retirement income, good. If people want to save less and retire later, or with less retirement income, fine. But various plans specify the amounts of saving, or the amount of payroll taxes that can be diverted into saving. In some cases, they go a bit overboard, particularly if you're good at picking stocks. On the left side of the overhead, we have that little bit from previous chart, from the Entitlement Commission. Social Security on a fully-funded basis can only afford to pay you about a 29% replacement of your pre-retirement income. It's promising 42% on average, but if we cut the benefits to match the revenues, it will only pay about 29%. If you put in a stock fund, you're going to
do much better than Social Security can afford to give you. And if half a loaf is a good thing, why not a whole loaf? Some people have suggested a 5% cut in the payroll tax invested in a similar fashion. And take a look at what that does. Now here I’ve shown getting rid of the benefits entirely. If you can put 5% of your income aside over a working lifetime, at the average after-tax return on private sector assets, that’s after the corporate income tax, it’s about 9% before the corporate tax and about 5% after it, you can get a 51% replacement ratio. If you’re adventurous and put it all in stocks, you can get about 107% ratio. You can get roughly two or three times from private investment, with about half of what Social Security is now costing you, in private saving.

Now one plan, Mark Sanford’s proposal, assuming that you’re going to be very cautious and putting it only into bond funds, suggests that you put 10% of your income into saving. He would cut the payroll tax eventually by 10%. Well, if you do a little better than that, you begin to get some rather striking results. If you get a 5% return, you can get a more than 100% replacement ratio, and if you put it all in stocks, you might end up getting a 217% replacement ratio. I hope, and indeed Mr. Sanford does — these plans let people get out of their accounts once they’ve reached a certain desirable level. There’s no point in impoverishing yourself when you are young to become a multi-millionaire when you are old.

Actually, this chart illustrates something else. Look at what Social Security is funded to get you by taking more than 10% of your pay and look what you could do if you had that money to invest wisely. That gap is enormous. And I guess it just shows you that economics is not the dismal science if you have a morbid sense of humor.

Anyway, once you have these funds, we have to figure out what access we’re going to allow you to get these funds. Another choice when people design the bills. I’ve heard some people get into very heated arguments about these points and I have to step back and kind of giggle a little. Should people be able to borrow from their retirement accounts before retirement? The pension industry says “no, you might take the money out and buy a boat.” Well, if you force people to keep the money in their retirement account until they retire, what’s the rationale for that? Government doesn’t want you to fall back on the social safety net; they want you to be able to take care of yourself in your old age. What if your child gets sick, what if you get laid off, what if you need money earlier in your life? If you run into a poverty situation at that point, you’re going to be on welfare or on unemployment compensation when you’re young. So the government is making you bank money when you’re old so it won’t have to take care of you then, but it’s going to pay you benefits now when you’re out of work. And if you think about it, the present value for those two outlays is going to be the same. And it’s just a little odd that government has that particular concern. But in any event, they do tend to want people to be locked in until they get to a certain age or a certain minimum amount in the account. And most plans do let you retire early or to reduce your contributions once you have a certain amount built up.

But the withdrawals are cause for concern in some quarters. When people begin to draw on these accounts, how much should we let them take out? What if they take it all out at age 59 or age 60, and they don’t leave enough for when they’re 93? So the question then is, should they be able to manage their own withdrawals, perhaps with some ceiling so that you have to leave enough in to sort of match your life expectancy as you get older and older. Sort of the reverse of what we make you do with the IRAs, where now the IRS says you have to take it out as of age 70, and you have to take it out in proportion to the number of years you have left on our life expectancy table. Notice you have two different policy wonks here: You’ve got the IRS guy who wants you to take it out as fast as possible
so we can collect the taxes on the deferred income, and the retirement policy wonk who wants you to leave it in as long as possible so you don’t impoverish yourself in your old age. They’re both trying to protect the budget and they have exactly opposite policy recommendations.

Another suggestion that such people make is that you be forced to sell your entire portfolio the day that you retire and put it into an annuity so the insurance company can tell you how much you can have every year. Other people then complain that if the market happens to be down that year — see the evil private market here — and you have to buy your annuity, you’re going to lose big. Of course, if they let you manage your own portfolio, you could live on the dividends for several years until the market came back and you wouldn’t have that problem. This is a policy wonk problem, not a market problem.

Well, those are some of the choices for designing a bill as to where the system ultimately might end up. But let’s talk for a minute about the safety net issues — those were the control issues. Let’s talk about the safety net issues in designing a bill as to where the system should end up. Social Security is hard to understand and fix in part because it confuses retirement saving with income distribution; it has a safety net feature and this universal retirement coverage aspect. There’s no reason why the two have to be linked in this fashion. How do we provide a safety net? And it’s related to the question of whether Social Security should be fully privatized and phased out, or whether there should be some residual function of the Social Security lingering after some portion of it is made private.

Let’s look first at disability and survivors’ benefits. Social Security provides benefits in addition to retirement income for workers and spouses. People with dependents, in fact, would have to do a little more saving, get a little higher return, to match Social Security benefits other than the basic replacement rate. They get some insurance services on top of it. Now should these aspects of Social Security be privatized or should they be kept in a separate program? Actually, these are insurable events — deaths and disability. If the disability insurance program were ended, as well as the retirement program, workers would have to buy disability insurance. You might make that mandatory, or you might let them figure that out themselves. They might need to beef up their life insurance. Now that would actually be a fairer thing than we have currently, because right now single people with no dependents are forced to buy life insurance through the Social Security system. And I think most financial advisors will tell you that the problem with buying life insurance if you have no dependents is that you won’t be around to enjoy it, because you have to die to get it.

Now the next issue would be how to structure a safety net for the other problem that Social Security deals with that is not insurable and that is poverty. Should the government provide a safety net for the accounts to make sure that everybody’s retirement account is high enough when they retire? Or should they have some basic retirement benefit that is independent of these efforts to make sure no one is poor? Or should they simply give money to those who find that they are poor when they get to old age without messing with the accounts? Should they do it, perhaps, through some other system, such as Supplemental Security Income? Ideally the private saving that workers could set aside if payroll taxes were reduced would exceed and replace currently funded Social Security benefits, and the retirement income would be the returns on the retirement saving, plus an annual prudent draw on the principal. But the financial assistance to low-income elderly would be provided based on their income from all sources, including other saving, inheritance, and any ongoing employment through a means-tested welfare program, such as Supplemental Security Income. And as with other welfare programs, the safety net would be funded with income taxes.

Many of the bills and proposals that are
kicking around, however, don't take that view. They would guarantee that minimum annuity. You'd put your money in, but if you had intermittent work history or low wages, the government would say that your account was not big enough to buy a good retirement annuity, as of a certain age, and they would make up the difference. And in some plans they would make up that difference even if you had a big inheritance waiting for you, or you had other sources of income. One of the proposals coming out of the Advisory Council would split Social Security into two tiers: There'd be a 5% payroll tax cut, which you would put into your saving plan, but there'd be a Tier 1 of benefits and everyone would still have to pay payroll taxes for it and everyone would still get it and it would pay about $4,900 a year — to me, to you, to the poor man down the street, and to Senator Rockefeller.

Well, we've covered the design issues of the ultimate system, but let's see how we can get from here to there. There's a whole bunch of choices involving that, and I'm going to go as fast as I can through them. We've got to face up to one fact: However you look at the transition, it's going to be a canine of the female gender. All reform plans will have to cope with the costs of the transition from the current system to a new arrangement, and every approach will involve near-term costs to one or another group in the population. The ultimate benefit to making the changeover would outweigh the near-term costs. But the costs must be faced. Several concerns need to be raised. Proposals to reform Social Security threaten to open up an immediate budget gap by delaying benefit cuts to protect current retirees, while cutting taxes immediately for current workers — through either a payroll tax reduction or a deduction for saving, or both — to enable them or encourage them to start saving against the day when their benefits will be reduced or eliminated, and to bribe them into accepting the benefit cuts. So we have a delayed spending cut and an immediate tax reduction. The transition problem is how to bridge the budget gap.

Some proposals would compound the budget gap by trying to pretend that Social Security in the past was some sort of investment and let even young workers who could gain so much from buying out of the system — to give young workers back some of their payroll taxes, or to give them some proportion of what the future benefits would have been for them. You don't need to do that to a young worker who has time to build up a large account. You would need to do something like that, however, in a transition for older workers who would not have much time to save under the payroll tax reduction to replace lost benefits. Either some benefits must be kept for those of a certain age and above, or they must be given some sort of buyout bond which would then, of course, itself have to be financed at a later time. That is the basic transition problem, and it's a difficult one.

But one thing we don't want to do is to approach it blindly. In the past, people have looked at Social Security and said, "Well, we'll fix it, we'll have a little tax increase here and a little benefit cut there," and not much attention is paid to the economic costs or economic effects of those options. So we have some choices to make. And the one thing I want to say is that financing the transition is going to require one of three steps. If you keep the outlays up now and cut the taxes somewhere for the younger workers now, you're going to have a gap, and you either have to finance it through additional taxes somewhere else, additional government borrowing, or reductions in government spending, either inside Social Security — but we've just said we can't do too much of that — or in other parts of the budget. Now financing the transition through additional taxes or additional government borrowing or reductions in government spending would have sharply different effects on national saving and growth, and on future tax receipts, and on welfare outlays and on other things, and we really do need to be aware of the difference that these various options would have, and we have to understand these various financing
possibilities and we have to understand them before we choose them. I don't feel the research has been done to educate the retirement community and the Social Security wonks on these choices.

If we want to have a transition that does the minimum possible damage to the economy in the process, indeed perhaps even strengthening it, we have to avoid draining national saving, we have to reduce labor costs, and we have to increase work incentives. Achieving these objectives requires that the government not borrow the money back, not tax the money back. It requires the government to find some spending cuts, and not necessarily in Social Security.

What about spending cuts? I wouldn't restrict spending cuts to Social Security because everyone in the country is going to benefit by transitioning to a private savings system. The whole budget ought to be explored for spending reductions. But we also have as a goal balancing the budget, and some in Congress would like to do that by 2002. How can we cut spending to balance the budget and still cut the payroll taxes? Isn't it impossible? Well, it would be difficult but not impossible. Even after the cuts in the Congressional Budget Resolution that was passed last year that was aimed at budget balance by 2002 — let's skip that one.

Discretionary spending would be reduced, so would some of the entitlement programs. On line 4 of the graph on the screen, you see that instead of growing to $1.4 trillion, the non-Social Security, non-debt service part of the budget would grow to $1.2 trillion. Those are the cuts the Budget Resolution calls for. There are some modest savings that you could count on by having a cut in the payroll tax which would indeed increase employment. You could trim some of the growth in the current Social Security benefit formula for people aged 55 and above if you're going to give them a payroll tax cut, and you're going to give them benefits, you ought to trim the benefits or you don't give them the benefits but you give them the payroll tax. You shouldn't do both. And there is a tax cut built into the Budget Resolution which you could apply to privatization. You'd still have enough spending cuts left to be a substantial number. And it would require an additional 9-11% cut in spending, and that is not easy; people will squawk.

There are other things you can do, and which several of the plans do — and be careful when you look at them. Some choose to raise other taxes. Some of the tax hikes take the form of a mandatory saving amount added to the current payroll tax, such as Chairman Gramlich's approach out of the Advisory Council and even the portion of the privatized saving in the more privately oriented faction of the Advisory Council headed by Phil Sheeber and others. Some of them borrow to finance it by imposing a payroll tax that is only part of what they need to cover the deficits in their plan. They borrow a great deal, then they keep the payroll tax on — the added payroll tax on — for another 20 or 30 or 40 years to pay off the added debt. You must watch these things. The tax increases will retard employment; the borrowing will cut into national saving.

Now assuming too much saving and growth is not a good idea, the promises of too much growth from this can be overdone. Some of the saving that would be done in these privatized accounts would replace saving people are already doing. Some of the saving will not go into capital formation, not in this country. Some of it might go abroad, which is fine. But it would not necessarily boost wages by as much as it were all invested here, and we shouldn't try to force it to be.

Another often-suggested remedy is asset sales. But the people buying the assets would have to dis-save by as much as the government gets for the asset sale, and that's not an answer. And then there are forced bond sales some of the approaches would have. Whether you force someone to buy a bond or induce them to do it voluntarily, you're still draining part of the saving pool. That is not an answer either, and you'll see
that in some of the proposals.

In conclusion, this can be done, and it will yield enormous benefits, but it’s not going to be a sure thing and it’s not going to be a snap. There’s a lot of education to be made. Now I just want to end on one little up note, the next chart. We have a very serious challenge; I don’t want to minimize it. Social Security is the comet that’s going to destroy the federal budget — and most of Washington, which isn’t necessarily a bad thing, but it would take the economy with it. And we do have to address the issue. But unlike the dinosaurs, we are reasoning beings, although somewhat short-sighted sometimes and somewhat money-grubbing sometimes. But if we can approach this rationally, we can get through this, and we can send the comet back into the outer darkness whence it came.

**Respondent: Mark Weinberger, Esq., Washington Counsel, P.C.**

I will be brief; I only have about 10 minutes to kind of set the framework for you about how this debate is going to proceed in the coming year. The first thing I’ve been asked to talk a little bit briefly about is how important is framing the issue to successful reform and defining choices. Second, is there momentum for reform? Is it going to happen. Now that one I hope I can handle quickly. Otherwise a lot of you wasted a whole day sitting here, so I assume you think that there’s an opportunity for it to happen. Third, I’ll provide just a brief framework for how to think about this, and I think Steve basically did that. And then finally, what is necessary to have successful reform? What do we need to see actually happen?

How one frames the debate will determine the range of outcomes and solutions, and is absolutely, in my opinion, critical to the process. Is the problem that Social Security is actuarially out of balance, as the Trustees tell us? Well, if that’s the case, then all we need to do is tinker around the edges and put it back into balance by playing with the numbers. Is the problem that the government can’t afford paying Social Security because of deficits, and therefore since Social Security is the single largest federal expenditure, about $340 billion last year and 22 cents on every dollar the federal government spends, is that the problem? If that’s the problem, then why don’t we look at things necessarily outside Social Security since Social Security is the most popular federal program, as poll after poll tells us. Is the problem that the system is inequitable, that similarly situated taxpayers don’t get the same amount of benefits? If that’s the case, you can fix that by fooling around with the benefit formulas within the system. Is it a problem that the system is generationally inequitable? Is the funding mechanism, payroll taxes, too regressive? Is that how we’re going to define the problem throughout the debate?

Is it a macroeconomic problem where government resources are being diverted from investments and entitlements? For example, in 1963, when President Kennedy was in office, for every single dollar the federal government spent, it had discretion over 70 cents and automatic pilot spending was 30 cents. We are at a point now where 66 cents of every single dollar the federal government spends is spent before it has any discretion, on entitlements and interest on the debt. Is that the problem? Is that why we want to look at Social Security? Or is the system just sending the wrong message that’s discouraging personal savings? Than maybe the libertarian view is what is correct: The government is too big and individuals should have the responsibility to save.

These issues and how the debate is framed — and you can answer yes or no in your own minds to all of those questions, and maybe it’s more than one issue that’s the problem with Social Security. But how we begin to talk about the issue and how policymakers decide to play it out is going to be crucial to the options we have, the choices we come up with, and the ultimate
solution. The title of this Conference, "Privatizing Social Security," it's a term, quite frankly, I never like to use. "Privatizing Social Security" has a lot of negative connotations with it to many sectors of the society, to many interest groups. What we're really talking about is maybe taking the system and reforming it and putting it into a market-based approach, where we're going to allow the markets to provide us a higher rate of return. How you talk about the issues is going to determine what type of choices we have and what type of solutions we will have. So I think, to answer the first question, how we frame the issue is going to be incredibly important.

Two, are we going to have Social Security reform? What's the momentum? Well I would venture to say 5 years ago none of us would have been sitting here in this room spending all day on a Social Security reform conference. The Entitlement Commission certainly put thinking outside the box with some sort of private investment approach on the table, and since then it's gotten even greater momentum. Senators Kerrey and Simpson have advocated plans, and being very respected Senators, bipartisan, they have moved the ball forward. Senator Simpson is now retiring and Senator Judd Gregg is going to be moving in to do a lot of that work. In the House, there's a Public Pension Reform Caucus, headed up by Congressmen Colby and Stenholm, who are focusing on this issue. There are some 40 members they have together now to think outside the box to reform the Social Security system. We did a survey in Washington of the different groups that were interesting in reforming Social Security, and there's at least 40 active projects in different think tanks and interest groups around town thinking about this issue. We had a meeting called by Third Millennium, a Generation X group, not too long ago that we hosted at Washington Counsel's office. We expected 15 people on the invitation list; our conference room is not that big, we're not a very big firm. As it turns out, we had nearly 50 people show up. And this is a non-congressional time period, and many of them were staffers from the Hill and many were from particular interest groups.

Over 20 countries have moved to majorly reform Social Security in a form similar to the form that we're talking about today. And I think that shows momentum abroad.

What will become in the short term very important to kick-start the issue and be a catalyst will be what Steve referred to: The Social Security Advisory Council — Quadrennial Advisory Council's Report will be coming out, we think, by the end of this year or early next year. That Council has never been a bastion for great unorthodox ideas. They're basically strong policy people appointed by the Administration who in a nonpartisan way are supposed to think of ways to reform the system. For the first time in my knowledge, since the Quadrennial Council was formed, they don't have a clear majority solution on how to fix Social Security. Interestingly, each of the three factions has a plan that relies on some form of investment in the marketplace. The traditional approach, which apparently is going to garner six votes when the report comes out, says that you would invest a portion of what currently is invested in Treasury bonds in the Trust Fund for Social Security in the marketplace. Now you may agree or disagree with that approach. I'm sure many of the people in this room have views on it, but it is a big change from what we've traditionally done. The law right now requires that all surpluses from the Social Security revenues are invested in Treasury bonds. This plan would allow up to a third of the assets of the Trust Fund after the turn of the century to be invested in the marketplace as opposed to Treasury bonds. That's one approach.

The second approach is a 1.6% mandatory savings program on top of Social Security. That mandatory savings program would have those funds invested in private accounts, managed by the federal government still, but directed by individuals and have some sort of index funds which you'd be
able to invest in.

And the third approach is the 5% reduction in payroll taxes with that full 5% going into private accounts. But the interesting common link is that all of them are looking to think outside the box of traditional fixes, which have been raising payroll taxes and cutting benefits.

So the momentum is there. The Quadrennial Advisory Council will add to it. And I think that you're going to see a lot of attention paid to this. In addition, one of the handouts I think you have is something that we put together which outlines over half a dozen bills that Members of Congress have put on the table and the choices they made in thinking through these very difficult issues to address how to have some sort of a private investment option approach in Social Security plans. Ten years ago, maybe you had one bill from one Member. Now you have bipartisan efforts by people in the House and the Senate clearly gaining significant attention. So the momentum is building.

Third, framework for analyzing the proposed solutions, Stephen did a great job. I don't know how much more I could add other than to say in the simplest terms you have one option, traditional fixes. What does that mean? Extend eligibility age for beneficiaries, cover newly-appointed state and local officials, which is in all the plans. What that does is puts more people in the payroll systems so it shores up Social Security slightly. Tax the benefits at a higher rate than we currently tax benefits. Raise payroll taxes; we've done it 17 times in the past. Increase the computation period for your working life as to how your benefits are calculated. The longer the period, the lower maybe the monthly average of wages. Means test the benefits has been proposed. Change the bend points is another option in traditional approaches, again, fooling around with the benefit formulas. Or, finally, CPI adjustment. All of those are kind of traditional approaches. The one thing they all have in common is they all make a system where — as Steve alluded to — investment by current workers into the system is turning into a very bad investment. When people first started paying payroll taxes back in 1937, they paid $60 for the year. It was 2% on $3,000. Well, now we have a base that's over $65,000, the rate has gone up to 12.4%, and when you add Medicare, it's an awful big chunk. And for the people who are going to be paying those over a longer portion of their lives, us in this room and the generations that come after us, the return gets only worse. So that will have to be something that will be addressed if you look at it as a traditional adjustment.

If you don't want to do traditional adjustments, or if you think something else is needed, some groups are advocating full privatization, taking all of the funds and putting them into private accounts. That is obviously, as Steve alluded to, a very aggressive and ambitious plan that would require a tremendous amount of thinking on the transition issue, primarily because it would not require the 12.4% of payroll to go into the Congress' and President's coffers — into the government's coffers — anymore. They'd have to get the revenue from somewhere just to meet their current obligations, because as I'm sure somebody talked about earlier today, the money that we are currently paying in Social Security benefits is not going into private accounts with our names on it, it's going to pay for current beneficiaries and it's going to pay for other government spending. And the only ability we have to make good on the bonds that are in the Trust Fund is the ability to tax future wage earners. So we're very dependent on future labor growth and growth in the economy. So that's the second possibility.

And then the third possible solution, which is where people are grappling with, is between the two — some sort of partial privatization, or some sort of separate account for private investment in addition to maybe a level of guaranteed Social Security benefits. Will any kind of private account be mandatory, or will it be elective? Will everyone have an ability to elect into it or
not? Do we deal with the different-age cohorts differently, since some people are vested in the system and some are not vested in the system? What are your investment options? Are you allowed to invest in derivatives? Are you allowed to invest in foreign markets? Are you allowed to only invest in what the Thrift Savings Plans have now in the federal government, which are certain index funds? Who’s going to do the investing? Is it going to be you and me making our own decisions? Is it going to be the federal government telling us how to do it? Who’s going to manage our accounts? What type of financial institutions are going to be entrusted with coming up with the plans? These types of issues have not been adequately addressed.

One of the biggest is this privately-funded portion on top of the existing 12.4% payroll tax and separate from Social Security? Or is it part of the existing Social Security system, therefore payroll taxes are reduced to do part of the funding? And very important, when you retire, how do you get your benefits? Are you going to be required to buy an annuity? Are you going to be allowed to take a lump sum? Or, as in IRAs, if we start giving individuals the right to put their own money in their own accounts, what have we seen Congress do? We’ve seen Congress provide liberalization of withdrawal for various functions – for education, for first-time homebuyers, for Medicare. Are we going to be able to have the necessary discipline to say that “this is retirement savings, it’s taken from Social Security, it’s got to be for retirement savings.” How do we get people to think about it that way. Those are all very tough issues.

I guess in my judgment, because they make the situation worse and because increases in payroll taxes are not palatable in this political environment, I think that the traditional adjustments are probably not going to be enough. I think that full privatization has a tremendous generational cost that’s difficult to deal with and hard to fund. And so I think we’re probably looking at some sort of in-between result of a mixed bag between private investment account and Social Security guaranteed payment for those who can’t afford otherwise.

How is this going to be done? Well, I’ve got just five points that I think are crucial. One, public education. Let me tell you, when I was the Chief of Staff for the Entitlement Commission, and we had our first hearing, we didn’t even have any options on the table yet, and we were just setting up our second hearing. We didn’t even understand the ramifications or the problems of Social Security. And we received in the mail 350,000 postcards from people telling us we were going to dismantle Social Security and that we were evil, basically. And that is because there is this great lack of understanding about the need for reform and the options for reform and how they can be dealt with out there. Something that if any politician is expected to have the will and desire to move forward on these issues, there needs to be a lot of ground covered with respect to public education about the need for change. So public education is first.

The most important issue, I think, to have a successful legislative effort on this will be that it be bipartisan. We’ve seen what happened with Medicare. Medicare became a very partisan issue. Medicare, even the proposals on the table originally by the Republican Congress in 1994 of $350 billion over the 7-year period was not enough to bring Medicare into actuarial balance, but it became a huge political hot potato and they pared back to $168 billion in Medicare cuts. We have to avoid the partisan battle of Medicare in the Social Security area if you expect to have any success.

Third, younger Americans have to take an interest in this issue to be successful. I’m glad to see so many of them here today. It is absolutely crucial because older Americans are scared that the federal government will take away their benefits immediately, whether that’s driven by interest groups, whether it’s driven by experience, whether it’s driven by whatever it may be, there has to be a counterbalance and there has to be a recognition that Social Security beneficia-
ries are not the 43 million people today, they’re the 100-and-some million people who today and tomorrow are going to get these benefits, and the system has to be designed and planned on that basis. And younger Americans, therefore, need to get involved in the debate, in my opinion.

Fourth, much more analytical work needs to be done. This is not a debate you can have, in my opinion, in the press, in the airwaves. It’s not something you want to stand up. It’s too easy to demagogue by those who might want to keep the system as it is. There has to be strong intellectual work done on generational equity issues, on risk return analysis, on administrative issues of how you manage these various accounts, on the effects of savings and growth of the current system versus what a privatized system might be, or even a partial privatization system might be.

Lastly, we can’t overpromise. The biggest mistake that I think policymakers make and have made, you saw it in health care where President Clinton came in in 1993 and had this massive overhaul he tried to stuff down the American people’s throats and they rebelled. Tax reform, quite frankly, same thing. A lot of very grandiose plans, not a lot of educational groundwork done, promising of all these huge benefits, and others were coming in and paring back the benefits and challenging what the advocates were saying, and the advocates found themselves on the defense most of the time, as opposed to the offense. Very difficult, but you can’t overpromise. As Steve said, any one of these approaches, if you want to fix this problem, will require shared sacrifice. So there is no silver bullet to get us out of these unfunded obligations we have today and to future beneficiaries.

I guess the last point I would make is timing. Timing is crucial, obviously, but I think that next year Congress is going to be preoccupied by a balanced budget by a date certain, be it 2002. So we’re going to be mired in a balanced budget debate, which is going to require an enormous amount of attention, strength, political will, and analytical work. In doing so, both parties have taken Social Security, at least apparently, off the table. Medicare is not off the table, and you hear all this talk about a Medicare Commission. Therefore Medicare will probably be looked at first, and how to shore up Medicare. That may push Social Security off. And I think that what that means is that you will continue to see a proliferation of plans, of ideas, of the groundwork being laid for the final proposal that will ultimately have to come. I mean, Social Security reform is inevitable; tax reform is not. Tax reform, in my opinion, is certainly beneficial but not necessarily inevitable. So it will come and the groundwork is being laid for that, but my guess would be that we’re not looking at it next year. We’re probably not looking at it being enacted 2 years from now. We are looking at it over a 4- or 5-year time frame to have this intellectual debate. And at that point, at the end of this time frame, the American people will decide whether they want it or they don’t. And so I think we have a lot of work to do in the interim.

The final point I’ll make is one, though, that I think is very important to Social Security reform, to balancing the budget, to everything else that we all should watch closely — because it does affect actuarial balance of Social Security, and it does certainly affect the long-term growth of all entitlement programs, or at least the majority of them, as well as taxing. That is the debate we’ll have next year on the CPI, whether the CPI overstates the cost of living or not. We saw a lot about that last year. Chairman Greenspan came out and said he thought it overstates the cost of living by 1%. There’s a Boskin Commission the Finance Committee put together that’s looking at this issue. They’re going to report by the end of this year. They are rumored to have found an overstatement of between 0.5% and 2% or somewhere around there. What does that mean? Well, it’s a significant amount of revenue that is saved if there is actually an overstatement. Forty percent of the savings comes from Social Security, 40% of it comes from taxes. It comes from
Social Security because obviously the increase in benefits each year will go up slower than they currently are, if it is being overstated. It comes from taxes because the indexation of tax bend points and how much you contribute to your retirement plans is indexed each year, so that gets slowed down. So therefore it will be a tax increase. And then the 20% is spread out among other programs like reimbursement rates for Medicare and things like that. If they do pass CPI, that will obviously have an effect on the actuarial balance of Social Security, and it's conceivable that those who are using the actuarial balance and solvency of Social Security as their argument for reform will be undermined.

And so I think that's why it's very difficult and we have to be careful how we frame the debate. This is not about actuarial balance. This is about pre-funding the baby boom retirement, and meeting our demographic challenges as we enter the 21st Century. And unless you talk about it that way, it's very easy to get caught up in traditional approaches.