Social Security Reform:
An Expository Report

Undergraduate Honors Thesis

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"For wisdom.
For support.
For opportunity.
For my parents."

. . . Thank you.

Honors Thesis Outline:

I. HISTORY OF THE SOCIAL SECURITY PROGRAM:

During the early 1930's the U.S. economy found itself caught off guard. The stock market was tumbling and war was imminent in Europe. Juxtaposed with the international political scene was the individual plight that characterized the majority of the country. Tuberculosis and polio were rampant, jobs were scarce and national savings rates were miniscule. Americans were fighting off destitution on the home front and the Third Reich was waiting for them on the other side of the pond. It was a difficult period in American history, and yet our country's leadership was able to implement several prescient plans that would eventually get our nation back on its feet. Among these were the WPA, the interstate system, and the Social Security Program. The latter is the focus of this expository report.

The Social Security Act was passed in 1935 in the wake of the Great Depression under the FDR administration. It was originally conceived as a vehicle of forced savings incentives that would provide social insurance, for all contributing workers in industry and commerce (except railroad employees, agricultural and domestic workers).

The Old Age and Survivors Insurance program can be found under Article II of the Social Security Act. It represents a fund that began originally collecting a 2 percent tax levied on earned income up to $3,000.[1] Since the creation of OASI, it has developed into an umbrella program, embodying our nation's largest federal outlay (23% of the budget in FY 2002) and a controversial system of intergenerational and demographic wealth transfers.

[1] $60, split with an employer, was the 1935 annual Social Security tax. In 2003 dollars this is the equivalent of $864 with a $43,190 limit (assuming an average inflation rate of 4 percent).

At its inception, OASI was considered "fully funded". It closely resembled an insurance policy rather than an entitlement. Originally, all covered workers *under* the age of 65 were included. Taxes were paid to the OASI fund, invested by that fund in the U.S. Treasury, and marked for repayment only to contributors, and only in the event that there was a qualifying need. However, persistent poverty (especially among the elderly), and the fear of the government building up excessive cash reserves while the Great Depression persisted forced the government to re-examine the OASI fund. As a result, in 1939 OASI was switched from a "fully funded" system to a "pay-as-you-go" system (PAYGO).[3] The implications of making this change are discussed in section II of this paper. The reforms of 1939 were also accompanied by an expansion of benefits to several groups of citizens that had not contributed to the system from its inception.

In 1939 the OASI program benefits were extended to the spouses and children of covered workers. Benefits were extended again in 1956 when the OASI program implemented a disability insurance element (DI).[4] Hence the acronym that represented 6% of the U.S. GDP in 2002, and our nation's largest public program today, is O.A.S.D.I. (Old Age and Survivors and Disability Insurance).[5] The broadening of the Social Security Program has resulted in 97.6% of the U.S. working population being covered today, as compared to 63.7% in 1940 (Dostey).

In addition to the changes made to OASDI benefits were the changes made to the program's income. In 1977 the legislature passed a "rescue package" for the SSA which,

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[3] United States General Accounting Office. Report to the Committee on Finance, U.S. Senate. "Social Security: Different Approaches for Addressing Program Solvency." July 1998.

[4] According to David E. Altig and Jagadeesh Gokhale in their working paper, 9703 from the FRB of Cleveland, benefits were extended several times to niches of the population as this program has broadened in scope and complexity. "Coverage was extended to seaman and bank and loan-association employees in 1939, to farm workers,

according to Michael Dostey at the Federal Reserve Bank of Richmond, was the largest peace-time tax increase in U.S. history. Payroll taxes were increased from 12.1 percent in 1977 to be 15.3 percent by 1990. This adjustment was intended to create a Social Security system that would be solvent for the next two centuries according to its supporters (Dostey). Although payroll tax schedules remained untouched after the 1977 Act, Congress revisited the program's income issue again in 1983 and began taxing Social Security benefits. Again in 1993, through the Omnibus Budget Reconciliation Act, Congress raised the bar by increasing the taxable fraction of those benefits to 85 percent. In 2002 Social Security recipients paid $13.5 billion in SS benefits back to the government in income taxes.

Although the numbers that are used to finance the largest federal program will always be a source of contention, the Social Security Administration is facing several obstacles that must be resolved regardless of who pays and receives what. These obstacles are mired in generational politics and could significantly change the way our nation saves for the future while providing a degree of social security. The ongoing and upcoming debates on Social Security reform measures are best understood after examining the current system as it exists today.

II. **THE CURRENT STRUCTURE OF THE SSA:**

The current tax structure of the Social Security Program (OASDI) is relatively simple. All payrolls are taxed at a current rate of 12.4 percent on all earned income up to $87,000; the tax being split evenly between the employer and the employee. The Medicare program receives an additional 2.9 percent of payrolls (with no income

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domestic workers, and public workers not already covered under a government program in 1950, to the self employed in 1954, and to employees of the uniformed services in 1956." P.6

limitations) that is also shared with employers and employees. Self-employed contributors pay the entire 15.3 percent tax on personal earned income. The Social Security Administration collected $627.1 billion in 2002.

Benefit calculations are complex at best.[6] An individual earns one credit for every $980 of annual earned income with a maximum of 4 credits per year. Once an individual has earned 40 credits they become eligible to receive benefits. Benefits are calculated using the Average Monthly Earnings Method (AIME) in computing the Principle Insurance Amount (PIA). PIA represents the actual monthly retirement benefit. The AIME computation is a wage index used to estimate average covered earnings over the past 35 years and applies a regressive formula to calculate the PIA.[7] The AIME method was introduced in 1972 when OASDI benefits were indexed with inflation to maintain purchasing power. Several problems have arisen from this benefit calculation method and will be discussed in section III of this paper.

The maximum monthly benefit for a recipient retiring at the full retirement age of 65 is currently $1,741. According to the Social Security Administration's publications the average monthly benefit in 2003 is $895 for unmarried recipients and $1,483 for married households. Once a benefit flow has been initiated, certain income limitations are imposed. For example, if an individual files for benefits prior to age 65, they will receive full benefits provided that they earn less than $11,520 per year. If an individual waits until 65, they may earn up to $30,720 per year. Benefits are reduced by $1 for every $3

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[5] In 1940 the original OASI program was .03 percent of the national GDP. (Dostey)

[6] For a detailed benefit analysis with respect to marital status, dependencies, disabilities, retirement ages, etc., see the SSA's *The Handbook of Social Security* Washington D.C.: Government Printing Office.

[7] Gokhale, Jagadeesh. "Should Social Security Be Privatized?" 15 September 1995.Federal Reserve Bank of Cleveland. Economic Commentary.

earned thereafter in both cases. The OASDI program, in all its complexities, distributes an annual $460 billion to roughly 50 million recipients.

Understanding "Pay-As-You-Go":

The current Social Security Program, implemented in 1939, is characterized by a PAYGO structure. This represents a "pay-as-you-go" system of simply converting taxes from workers into benefits for retirees. By nature, the PAYGO system does not "invest" for the future as our political leaders have propagated. Instead, the PAYGO system simply transfers the Social Security tax that is paid by current contributors to the current recipients. Because monies are not being invested solely for the specific individuals that contributed them, the financial solvency of the PAYGO system is dependent on the growth rate of the taxable wage base (inflows) and the growth rate of benefit obligations (outflows).

The growth rate of the tax base, in the long run, is equal to the rate at which the work force grows plus the rate of productivity growth. Unfortunately, real wage growth has slowed over the last two decades, largely reflecting slowing productivity growth. This contrasts with the 25 years following WWII when the standard of living doubled due to productivity growth.[8] Over the last 50 years the taxable wage base growth has been 3.2 percent. Over the last 25 years that number has been 2.5 percent. The latter is a widely accepted as a benchmark for the future.[9] The cause of slow growth is not a lack of investment. Business's fixed investments within the U.S. average 10.4% of GDP. The

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[8] United States General Accounting Office. Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate. "Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform." July 1997. p.20

[9] Cogley, Timothy. "On the Transition to a Fully Funded Social Security System." 13 March 1998. FRBSF Economic Letter. Number 98-08. p.1

reason the U.S. economy has experienced moderate productivity growth in the face of such high investment rates is because the stock of existing capital in the U.S. economy is already so large that even enormous annual investments increase it only marginally.[10] Demographic studies have repeatedly shown that the United States is going to see roughly 75 million baby boomers (born between 1946 and 1964) enter into retirement age within the next 3 to 10 years.[11] This will further reduce a slowly growing taxable wage base while drastically increasing the government's benefit obligations. Although the PAYGO structure was originally intended to smooth the economic shock of war and market failure by deferring certain costs onto future generations, it has proven to be a fundamental hurdle when deficits are forecasted and when productivity growth slows.

Surpluses & Deficits: The Trust Fund

The taxable wage base is currently larger than the benefit obligations. This generated a $158.4 billion surplus in 2002. When an annual surplus is generated from growth in taxable wages or decreasing benefit obligations, it is federally mandated that it be invested in Treasury issued debt. This $1.378 trillion account, backed by government debt obligations (IOU's), is commonly referred to as the social security trust fund, the "lock box", or any one of many attractive political tag lines. The OASDI surplus account is credited with average interest earnings of 6.133 percent. Last year the surplus earned $76.8 billion in interest revenue.

Surplus Issues: "Unified Budget"

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[10] Adler, Moshe. "Saving Social Security with Snake Oil." Plan Sponsor May 1997: 67

[11] "Unity in a Fragmented Report" Nation's Business March 1997: 71 & Dentzer, Susan. "Raising the Stakes." Modern Maturity. Jan./Feb. 1999: 43

The surpluses created by the SSA and credited toward the Trust Fund are technically considered an off budget item. This means that the excess economic utility (surpluses) that is set aside for the time being cannot be considered as part of the rest of the federal budget, and the economic utility which it represents. Many of the reform proposals are mired in unified budget debates on appropriate accounting methods. Those who downplay the gravity of budget deficits use the unified budget to show that Social Security surpluses offset overspending. Those who view SS surpluses as a debt that will need to be paid back with either income taxes or government savings choose to quote separate budgets to show larger deficits in the general budget. However, although the Social Security Trust Fund is technically excluded from the budget, its finances contribute to the government's impact on the economy by reducing the Treasury's need to borrow money from the public. Therefore Social Security is included, along with other federal programs, in the commonly used "unified" budget measure.[12] "It is simply an accounting convention on which confusion perpetually reigns," according to Jagadeesh Gokhale, a leading economist at the Cleveland Federal Reserve, "The fact that Surpluses are invested in Treasury Securities means that on and off –budget items can not be cleanly separated. Thus the appropriate concept is the unified budget."[13]

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[12] United States General Accounting Office. Report to the Special Committee on Aging, U.S. Senate. "Social Security Financing: Implications of Government Stock Investing for the Trust Fund, the Federal Budget, and the Economy." April 1998. p.4

[13] Altig, David E., and Jagadeesh Gokhale. "Fixing Social Security: Is the Surplus the Solution?" Federal Reserve Bank of Cleveland. 1 April 1999.

The following (overly simplified) example briefly shows the difference. Under a unified budget the first income statement seems to be in balance. However, when represented separately with the same numbers, the second income statement shows a $25 deficit. Under separate budgets the U.S. government would have to issue debts from the Treasury to pay for this. However, under the unified budget accounting methods, the Treasury borrows the entire SS surplus at a much lower rate to balance the budget, and to make existing debt payments.

Unified Budget		**Dr.**	**Cr.**
Income			
	1. Income Taxes	$200	
	2. Payroll Tax	$100	
Expenditures			
	1. Government Expenses		$225
	2. Social Security Benefits		$75
		$300	$300

Separate Budgets		**Dr.**	**Cr.**
Income			
	1. Income Taxes	$200	
Expenditures			
	1. Government Expenses		$225
		$200	$225
		-$25	

III. **PROBLEMS:**

The fundamentals of the current Social Security system (i.e. PAYGO, & "Unified Budgets") haven't changed much since its inception in 1935 and its draconian modifications in 1939. Although the system has served us well for 63 years, the tracks ahead are full of potentially derailing issues. Most Americans want to see the system survive, but few have paid close enough attention to know exactly what the issues are. A widely joked about 1994 poll shows that more Americans believe in UFO's (46 percent) than think SS will still exist by the time they will retire (28 percent). Although the poll was undocumented, its good-humored approach to proving a point does just that. Do

Americans have more faith in apparitions than they do in our political process? Granted, most politicians consider addressing the problems and solutions of Social Security as the third rail of politics; touch it and the voters (particularly the elderly) will kill you. However, a groundswell of broad demographic, financial, and ideological issues are becoming unavoidable regardless of the political risks.

Demographics:

The most unavoidable of these issues prompting reform are the demographic trends that have developed which promise to change the paradigms of need and political influence. The first of these is an aging population. According to census projections, the U.S. population 65 and older has tripled since 1940 and will more than double again by 2050. This correlates with a report from the Federal Reserve Bank that the elderly population is expected to make up 20 percent of the population by 2030 as compared to 13 percent today. These two estimates are widely recognized by the SSA and their implications are many. Due to an existing PAYGO structure that depends on a strong taxable wage base, the Social security system will be thrown off balance as the number of working Americans per retiree decreases.

That balance has slowly been sliding toward insolvency from the program's founding decades. In 1945, only six years after the SS system was originally switched to a PAYGO structure, there were 42 contributors to the system per beneficiary. In 1950, before the Social Security system was mature, the ratio was 16.5:1. In the 1960s, the ratio averaged 4.2:1. Today it is 3.4:1 and it is expected to drop to 2:1 by 2030.[14] To further demonstrate this trend, consider the 9.7% annual growth in beneficiaries from 222,488 in

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[14] United States General Accounting Office. Testimony Before the Special Committee on Aging, U.S. Senate. "Analysis of Issues and Selected Reform Proposals." January 2003. p.4

1940 to 37.5 million Americans in 1995. This does not include the 75 million Americans expected in the "baby boom generation," the oldest of which are expected to begin retiring by 2006. The aging population coupled with a rising life expectancy, and fertility rates that will be below replacement by 2030 are beginning to present the need for Social Security reform regardless of the third rail.

High Benefits:

In addition to demographic trends affecting the SS tax base and the number of retirees is the problem of how much is paid to each retiree. Social Security benefits have been rising much faster than the growth in the taxable wage base. For example, "in 1953 the maximum benefit was equivalent to 30.5% of the average wage. By 1981 the corresponding figure was greater than 50%, and in 1995 it equaled 60.5%."[15] Despite rising average wages, the government actuaries also omitted to recognize a shrinking tax base due to sharply declining fertility trends after 1960. The result was a further imbalance between benefits and income.[16*]

Prior to 1972 any increases in benefits were conducted on an ad hoc basis. However, during the Social Security reforms of 1972 benefits were indexed with a combination of the cost of living adjustments (COLA) and wage growth. This created automatic price adjustments that double-counted wage growth factors. The wage growth indicators were used inherently in calculating the COLA figures and then again independently. From 1950 to 1960 the average monthly benefit rose by 3.54 percent each

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[15] Marcks, Ronald H. *Social Security's Most Basic Infirmity.* The Wall Street Journal, January 16,1997.

[16] United States General Accounting Office. Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate. "Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform." July 1997.

* The fertility rate in 1960 was 3 children. Today it is a little over 2. By 2030 it is projected to fall to 1.95.

year. However, from 1960 to 2003 the average monthly benefit has risen 3.7 percent each year. Also contributing to the benefits imbalance is the benefits that were paid out two years early to the first recipients. Originally the OASDI program would have begun benefit outflows in 1942. However, the 1939 legislation moved that date ahead to 1940. A commonly cited sound bite regarding the excessive rates of return that retirees have received since the program's inception is as follows:

"Ida May Fuller was the first OASDI recipient. Beginning on 1/31/40, she received $22,888.92 in aggregate benefits over 35 years until dying at 100. The irony is that she only paid in for three years for a total of $24.75.

Financial Imbalance:

The rapidly increasing per capita benefit award structure, coupled with the dramatic demographic shifts that are quickly approaching leads a reformer to ask, "How much time is there?" Under the Trustees' intermediate assumptions, combined program outlays begin to exceed dedicated tax receipts in 2017 (see fig. 3).[17] By 2041 the Social Security Trust Fund will be depleted and the revenues are projected to be 14 % less than expenditures; resulting in only 77% of benefit obligations being fundable.[18] This creates a future unfunded liability. The SSA estimates the future value of this to be $8.7 trillion.

Currently 41% of annual pre-retirement earnings are replaced by SS benefits. In the ensuing public debates this is simply referred to as the "replacement ratio". The Federal Reserve Board estimates that in order to maintain the 41% replacement ratio, the payroll tax rate would

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[17] United States General Accounting Office. Testimony Before the Special Committee on Aging, U.S. Senate. "Analysis of Issues and Selected Reform Proposals." January 2003. p.7

[18] United States General Accounting Office. Report to the Chairman and Ranking Minority Member, Special Committee on Aging, U.S. Senate. "Retirement Income: Implications of Demographic Trends for Social Security and Pension Reform." July 1997.

have to rise to 18.6% from 15.3%.[19] Of course, this is assuming that the only way to fund the Social Security Administrations obligations is by raising taxes. To make a bad situation worse, the year 2017 is only one year after Medicare's Hospital Insurance (HI) Trust Fund outlays are also expected to exceed program tax revenues.[17] At this point both programs will depend on the Trust Fund, which is inseparable from the remaining federal budget (which is contributed to with income taxes) under the unified budget accounting principle.

The Trust Fund Myth:

In researching several resources published by the Federal Reserve Bank, there seems to be an underlying understanding that the Trust Fund is an accounting fiction. From an economic perspective, no such fund exists. Here is how it works:

1. Money from payroll taxes is collected. Payments are made to current beneficiaries, and money is left over.
2. By law, treasury bonds must be purchased with that remaining money.
3. Social Security will redeem these bonds in future decades to meet benefit obligations.
4. When a treasury bond is purchased with leftover Social Security revenue that money goes to the federal government. Congress, in the past, has spent that money. But the Trust Fund idea emerged with the understanding that the money instead would be used to reduce the federal debt.

Under this theory, federal debts are reduced and the national economy is stronger. So when it is time to redeem the bonds in the trust fund, the government is in better financial shape to do so.[20] In theory this sounds great. However, in practice, the funds made available to the government at relatively low rates have only induced the further spending of those funds. In 2002 the federal budget ran a $159 billion cash deficit. This includes the $158 billion in OASDI surpluses. The debate in Washington D.C. regarding the Social Security "lock box" is on whether the federal budget should be allowed to use OASDI surpluses for anything other than

[19] June Economic Trends. "Social Security – A Problem." http://www.clev.frb.org/Research
[20] Strope, Leigh "Social Security Trust Fund is Healthy." The Pioneer 30 August 2001: A1+

making payments on and redeeming federal debts. Those that say "No" maintain that OASDI surpluses should remain sacrosanct. Others maintain there are other ways of investing which will also improve the financial condition of the federal government. Examples include investing in income producing assets for S.S. benefit purposes, or in social development programs (schools, job training, temporary wage subsidies, etc.) intended to increase the taxable wage base and productivity.

To strip the problem to its essentials, when the time comes to tap into the OASDI Trust Fund the American people will find that Social Security is an extension of the income tax structure instead of a savings initiative to fund a proprietary account. The prospective revenue of future unified budgets (derived from income tax) is all that guarantees the IOU's that are exchanged with the Treasury Department. Those prospective revenues come from income taxes and expense cuts. While no one believes that the government will default on the bonds, it must still find billions of dollars with which to pay them. To do this, under a pay-as-you-go benefit structure, the federal government has two choices; raise taxes and/or cut spending.

Intergenerational Wealth Mobility:

At first glance it is a simple choice. However, the current debates on Social Security reform transcend financial matters. Another hotly debated issue is one of income/class benefits and intergenerational mobility. The current PAYGO structure under a unified budget has thus far produced results consistent with the program's original mandate [beginning in 1939]; to reduce poverty among the elderly and smooth economic shock across several generations. However, many proponents of reform, particularly those in favor of privately invested accounts, have made a case for the current system being the poor man's intergenerational hurdle; preventing the accumulation of bequeathable wealth. The essence of this argument rests on the fact that a lifetime of contributions is forcibly converted into a [joint] life annuity. The benefits flowing from that annuity, regardless of sufficiency, cease upon the death of the recipient and his/her spouse. In effect there is none, or very little, bequeathable wealth if Social Security benefits constitute a large fraction of postretirement income. There is significant empirical evidence suggesting that Social Security benefits compose a larger fraction of post-retirement benefits in low preretirement income households than in their higher earning peers. The four sources generally considered under retirement income are pension earnings, personal savings, wage earnings, and OASDI benefits. Low preretirement income households may only have limited wages and Social Security benefits. The benefits of privatization proposals are apparent in the form of intergenerational mobility. That is to say the chances of all future generations enjoying higher inflation adjusted earnings are better if present contributors are able to accumulate beqeathable wealth. The benefits of such a policy change would be enjoyed by households of all income levels. Currently, according to the Survey of Consumer Finances conducted by the Federal Reserve, 1 percent of the population owns 33% of all bequeathable wealth. Five percent owns 50 percent, and 10 percent owns 66 percent. That survey clearly shows that low income households are significantly deprived of the opportunity to save for future generations. It is assumed that these savings will take place in the absence of forced annuitization under the current system.

IV. <u>SOLUTIONS:</u>

Why Save Social Security?

After considering the most substantial problems facing the Social Security Administration one might be ready to scrap the entire program and start over. After all, why should public dollars support a system that is actuarially and financially insolvent? Why should a public program that keeps the poor man down deserve endorsement? Why save Social Security? The reasons politicians are willing to modify the existing system are many. The transition costs of radical reform are paramount among those reasons. In addition there are benefits that the current system does create. For example, the social effectiveness of the current system is widely recognized. From the standpoint of helping the poor, SS currently provides over 90% of income for half of the seniors below the poverty line and 50% of income for 2/3 of all recipients.[21] Policy makers also consider that in 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were considered poor, and 48 percent would have been poor without Social Security.[22] These numbers illustrate just how indispensable a Social Security system is. It is also the government's role to provide this system rather than allowing the private markets to simply invest for the future of an individual. The private markets have no mechanism for investing in a social insurance program that would share the costs of market failure or social tribulation between generations. Understanding that it is necessary to have such a program, and that it is one of the government's many self-declared responsibilities is essential before any credence is lent to the following proposed modifications to the Social Security Program.

1994-1996 Advisory Council on Social Security:

In 1994 a bipartisan Advisory Council on Social Security was appointed by Congress to explore the options of the Social Security Program. The goals of any reform proposal vary by author. Republicans tend to focus on the building of individual equity while Democrats on adequacy of benefits for all recipients. According to Jagadeesh Gokhale at the Federal Reserve Bank, the product of reform should be as follows: 1)More real investment, 2) Restore

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[21] Dostey, Michael. "Investing in Equities: Can it Help Social Security?" Federal Reserve Bank of Richmond Economic Quarterly Vol. 83/4 Fall 1997: 49

[22] United States General Accounting Office. Testimony Before the Special Committee on Aging, U.S. Senate. "Analysis of Issues and Selected Reform Proposals." January 2003.

individuals' incentives to work, and 3) Reduce or eliminate the intergenerational redistribution that leads to low national saving.[23] Albeit a simple three, easily understood objectives, three complex proposals were the result of the 1994-1996 bipartisan Advisory Council on Social Security. By 1996 three proposals were heavily discussed. While they disagreed sharply on details, all three of the council's factions made recommendations concerning private investment. They also considered several "quick fixes" which would work within the current system by either increasing revenue or decreasing expenses.

Increasing program revenues without making fundamental changes to the existing system included expanding coverage to the currently uncovered workforce (Federal and State employees with TSA accounts), increasing payroll taxes, increasing the limit on taxable income, and redirecting Trust Fund Assets to higher earning investments (government controlled privatization). Proposed changes intended to reduce expenses involve changing the lifetime earnings formula to include three more years (the earliest and lowest earning years), further raising the normal retirement and early retirement ages (NRA and ERA respectively), improving the COLA calculations used in the AIME method of calculating the PIA, and by implementing more stringent means testing (further reducing benefits if post-retirement income exceeds certain thresholds).

Raising payroll taxes are perhaps the most controversial of the income increasing reforms. It is estimated that raising rates by 2.2 percent, evenly shared between the employer and the employee, the insolvency issues would be eliminated over the next seventy-five years. The economic ramifications are increased labor costs for the employer and decreasing disposable income for employees. There are also work disincentives attached. The foremost of these being

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[23] Gokhale, Jagadeesh. "Structural Reform of the Social Security System: The Time Has Come." 15 February 1997. Federal Reserve Bank of Cleveland. Economic Summary.

that increasing payroll taxes do not necessarily create better future benefits for contributors. Expected benefits are actually expected to remain static at best. This is due to the PIA calculations that consider average lifetime earnings rather than an individual's actual increasing contributions.

Each of these proposed changes are accompanied by economic costs and disincentives. None of them fundamentally change the Social Security Program to include more real investment, more savings incentives, or reduced levels of intergenerational transfers. If implemented, the PAYGO structure remains in full form and the unified budget debates continue on.

2001 President's Council to Strengthen Social Security:

Although the Council did not come up with the single panacea, it concluded its study in 1996 having laid the groundwork for future, more refined solutions, which are surfacing today. Each proposal that has endured the last seven years pertains to varying methods of investing in the private markets. In 2001 President Bush convened a 16-member panel to make specific recommendations on the preservation of Social Security for the retired and on the wealth building issues concerning younger Americans. The Commission was given six guiding principles:

1. Modernization must not change Social Security benefits for retirees or near-retirees.
2. The entire Social Security surplus must be dedicated only to Social Security.
3. Social Security payroll taxes must not be increased.
4. The government must not invest Social Security funds in the stock market.
5. Modernization must preserve Social Security's disability and survivor's insurance programs.
6. Modernization must include individually controlled, voluntary personal retirement accounts, which will augment Social Security.

In accordance with these six principles, the commission developed three recommendations that are the foundations of reform discussions today. All three recommendations involve the creation of personal accounts, theoretically improving the financial solvency of Social Security, increasing national saving and reducing the transition costs that would normally have been a burden on future generations.

The first model will accumulate $1.1 trillion in assets by 2075 through a "quick fix" that will require additional funding in 2030. It proposes to allow workers to voluntarily invest 2 percent of their taxable wages (maximum of $1000) in an individual account. Subsequently, that individual's Social Security benefits under the current system would be offset by the individual's contributions which would be compounded at 3.5 percent above inflation. This would provide larger individual retirement benefits than an individual would expect under the current system. Critics however are focusing on the drawbacks of future funding problems. They argue that under this plan, a 27 year balance [without additional funding] implies an imbalance in 27 years. The commission itself also declared that the two percent proposal would be the most expensive in terms of transition costs ($12 million annually until 2012, $64 million annually 2014-2018) and would take the longest to return the program to a state of financial solvency.

The second model of reform establishes a voluntary account without requiring additional worker contributions. It is designed to provide larger inflation adjusted benefits for future retirees by allowing 4 percent of payroll taxes to be invested (maximum of $1,000 adjusted for inflation). The individuals' benefits under the current system would be offset by contributions compounded at an interest rate of 2 percent above inflation. It is estimated that this model would create $12.3 trillion in personal savings (present value estimated to be $1.3 trillion) and create a positive cash flow at the end of the 75-year valuation period. Model 2 also proposes to reform the growth in benefits problem by converting from an inflation indexing method to an index representing the growth of the taxable wage base. The only foreseeable drawback to this proposal is the estimated need to borrow from the general revenues of the federal government between 2025 and 2054. Although burdensome, it is estimated that the cash surpluses thereafter would be sufficient to repay those debts.

The third model proposes that 2.5 percent of payroll taxes (maximum of $1,000 indexed with inflation) be invested in a personal account on behalf of any contributor who voluntarily invests an additional 1 percent of his/her taxable wages. The additional employee contributions would be partially subsidized for them by a progressive tax credit system. As with the previous two models, an individual's Social Security benefits would subsequently be offset by the contributions made (compounded at 2.5 percent above inflation). The commission estimated that this reform model would require temporary general fund transfers between 2034 and 2063. Similar to Model 2, this translates into either modifications to the income tax structure or reduced government spending. The third model represents a careful compromise between asking the American public to save more while not perpetually requiring the general revenues to subsidize Social Security. Appendix 2 was taken from the Commission's final report. It effectively compares the three models.

The three proposed models of reform put forth by the President's Commission to Strengthen Social Security have served as the foundation for the proposals being put forth most recently. These include Social Security Protection Act of 2002, the 21st Century Retirement Security Act (Stenholm TX Rep.-D), and the list of bills currently in committee (See Appendix 1). These are the pieces of legislation that will transform the way America cares for its elders.

V. CAVEATS:

Caring for the retired population by investing in the private markets will neither change demographics nor will it change the country's productivity. Rather, the privatization of payroll tax dollars is founded on the premise that the average return spread between public and private markets will lighten the burden on the current system; a system that must deal with demographics and productivity growth.

Market Risk:

As with any political reform there will be the critical and the cautious objections. The idea of having the government involved, albeit passively, in the private markets has some opponents whispering "Socialism". Critics have also been emboldened by the market volatility of the last couple years. They claim that retiring during a long lasting bear market would have devastating consequences on entire generations. These concerns are carefully weighed against the reforms that are necessary to ensure long term financial sustainability. One could argue that if privatization was not pursued, the political risks associated with "quick fixes" under the current system could lead to even more unpalatable policy changes in the future. Moreover, privatization proposals are developed with a 75 year timetable, and it is widely accepted that market risk and time horizons are inversely related. This evidenced by the fact that the market for stocks has averaged 10.7 percent from 1926 – 2001 with a 6% equity premium. This average includes the period of the Great Depression, the bear market of the 1970's, and the beginning of the longest (and third worst) bear market in 60 years.

Price volatility alone may not be the biggest concern on the minds of some analysts. Political actions and its fundamental influence on market incentives are a less discussed (and potentially more important) concern. The Social Security Administration will more than likely not be the office in the spotlight controlling privatized retirement funds because of obvious socialistic fears. It is far more likely that the SEC will oversee the selection and regulation of the investment portfolios made available to private payroll tax monies. These portfolios will be heavily regulated. Perhaps it would be fair to say that the regulation efforts would be directly proportional to the degree of media coverage and political pressure by special interests. In any case the government controlled privatization will create a metaphorical "market high ground" on an otherwise level playing field. When markets dip, and they always do, this highly regulated section of the equity market will be a safe haven; perhaps another leading indicator of investor confidence. In other words as uncertainty builds in the market, one could literally watch investors jump ship and buy into a price bubble associated with the residual open market shares offered by the federally selected companies.

The Big Shuffle:

Although the opportunity to create more individual wealth in the private market is becoming apparent, there are significant caveats in addition to market risk. From a macro-economic perspective, the additional flow of wages into private markets does not implicitly create growth in national wealth. The increase in trust fund [or individual account] holdings would simply displace the current private market positions. It is widely accepted among economists that this reshuffling of the nation's assets produces minimal national financial benefit. David M. Walker, Comptroller General of the United States under the GAO, estimates that the transition to a new Social Security Structure will produce an aggregate cost of $2.2 trillion[24]. When the aggregate transition costs are weighed against the minimal national financial gains it becomes clear that privatization will not increase national saving, nor will it increase the GDP growth rate, both of which are necessary. The situation becomes more imperative when one considers David M. Walker's cost estimate of the current system over the same time frame.

According to Walker, $3.4 trillion is the amount of general fund infusions necessary under the current system; essentially the cost of doing nothing. Now one is back to square one, looking for the cheapest and most effective solution to increase national saving and produce secure retirement benefits.

Even if there is a panacea that will accomplish all of the privatization goals, the issue of administration cost is another caveat. Chile, under the direction of Jose Piñera, is often cited as having built the ideal private account structure. The national savings rate rose to 26 percent and composes 4 percent of Chile's GDP. Even though the Chilean economy is relatively small, these are numbers that warrant attention, perhaps mimicry. However, do the benefits also warrant administration costs of 3-4%? The Social Security Administration currently maintains administration costs less than one percent. Brazil, The Slovak Republic, China and Japan are also making the news with public pension reforms and experiencing the same hurdles.

VI. Conclusions:

Social Security, as we know it, is not the shinning financial salvation it has promised to be. The PAYGO structure itself is fundamentally derailed by demographic projections. The growth of the taxable wage base certainly is not sufficient to honor the booming benefit obligations through the next quarter century. Social Security is also viewed by the public as a tax rather than a savings incentive because of low rates of return; therefore, decreasing savings rates. To top it all off, wealth/class disparities are perpetuated due to an individual's wealth not being inheritable. Clearly something must be done.

Privatization has been propagated as the vital equity infusion needed by a "sickly" system. The prima facie evidence suggests that younger generations could transition from the PAYGO system into a more equitable private system by taking advantage of historically higher

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[24] Asenza, Jennifer. Social Security This Week. The CATO Project on Social Security. January 30, 2003.

rates of return over long time horizons. The baby boomers are enticed by the notion that the benefit obligations under the current system (regardless of sufficiency) will be honored rather than questioned. If it were just that simple, the switch would have been made years ago.

The political and economic landscape is more of a minefield of concerns. Bills are generally short-lived in committee waters; torpedoed by special interest groups. The public is fearful of government controlled securities, and the government is fearful of privately controlled accounts. The federal government also concerns itself with issues of fraud, transition costs and the effects of privatization on the remaining federal budget.

It is a widespread opinion that privatization, to some degree, is an appropriate concept. When and how privatization will be brought to fruition depends largely on political timing. Perhaps an emboldened second-term president will successfully maneuver significant legislation. Perhaps a period of high inflation would make the equity markets more attractive. One could reasonably foresee action being taken within the next two years as the eldest baby boomers influence the polls. The end result will most likely be some variation of the aforementioned reform models. Any subsequent actions taken after privatization reform will most likely resemble an extension of the income tax system. In any case, the appropriate political timing is imperative to a sound financial future for America's largest public program.

The clear solution is easily muddled in peripheral issues of accounting methods, benefit calculation flaws, burdensome taxes, intergenerational wealth mobility, etc. However, the situation and solution can easily be summed up in the words of Moshe Adler, an economist in the urban planning department at Columbia University:

"Savings and investment alone will not solve the current problem. What matters is what we spend our resources on. As a society we can prepare by making sure that we will have the necessary resources to take care of an aging population's needs. In some cases this will mean changing what we produce, putting more emphasis on goods and services that serve the needs of the retired. Life with a larger retired population will be different, and we had better get used to it."

29 . To amend the Internal Revenue Code of 1986 to repeal the increase in the tax on social security benefits. (Introduced in Senate)[S.767.IS]
30 . Social Security for Americans Only Act of 2003 (Introduced in House)[H.R.489.IH]
31 . No Social Security for Illegal Immigrants Act of 2003 (Introduced in House)[H.R.1631.IH]
32 . International U.S. Seniors Act of 2003 (Introduced in House)[H.R.1880.IH]
33 . Social Security Beneficiary Tax Reduction Act (Introduced in House)[H.R.423.IH]
34 . Medicare Mental Health Modernization Act of 2003 (Introduced in Senate)[S.646.IS]
35 . Prevent Bank Fraud by Terrorists Act of 2003 (Introduced in House)[H.R.1037.IH]
36 . Medicare Mental Health Modernization Act of 2003 (Introduced in House)[H.R.1340.IH]
37 . Notch Fairness Act of 2003 (Introduced in House)[H.R.97.IH]
38 . To amend title XVIII of the Social Security Act to make a technical correction in the definition of outpatient speech-language pathology services. (Introduced in Senate)[S.568.IS]
39 . Social Security Fairness Act of 2003 (Introduced in Senate)[S.349.IS]
40 . Medicare Equity Act of 2003 (Introduced in Senate)[S.36.IS]
41 . Seniors Health and Independence Preservation Act of 2003 (Introduced in Senate)[S.306.IS]
42 . Seniors Health and Independence Preservation Act of 2003 (Introduced in House)[H.R.960.IH]
43 . Medicare Fraud Prevention and Enforcement Act of 2003 (Introduced in House)[H.R.18.IH]
44 . Seniors Health and Independence Preservation Act of 2003 (Introduced in House)[H.R.983.IH]
45 . Seniors Mental Health Access Improvement Act of 2003 (Introduced in Senate)[S.310.IS]
46 . Personal Information Privacy Act of 2003 (Introduced in House)[H.R.1931.IH]
47 . Senior Citizens Tax Elimination Act (Introduced in House)[H.R.1897.IH]
48 . Senior Citizens Tax Elimination Act (Introduced in House)[H.R.424.IH]
49 . Senior Citizens' Tax Relief Act of 2003 (Introduced in House)[H.R.378.IH]
50 . To amend the Internal Revenue Code of 1986 to repeal the 1993 increase in income taxes on Social Security benefits. (Introduced in House)[H.R.860.IH]

Appendix 2 – Comparison of the three models proposed by the 2001 Commission to Strengthen Social Security. Found in the final commission report.

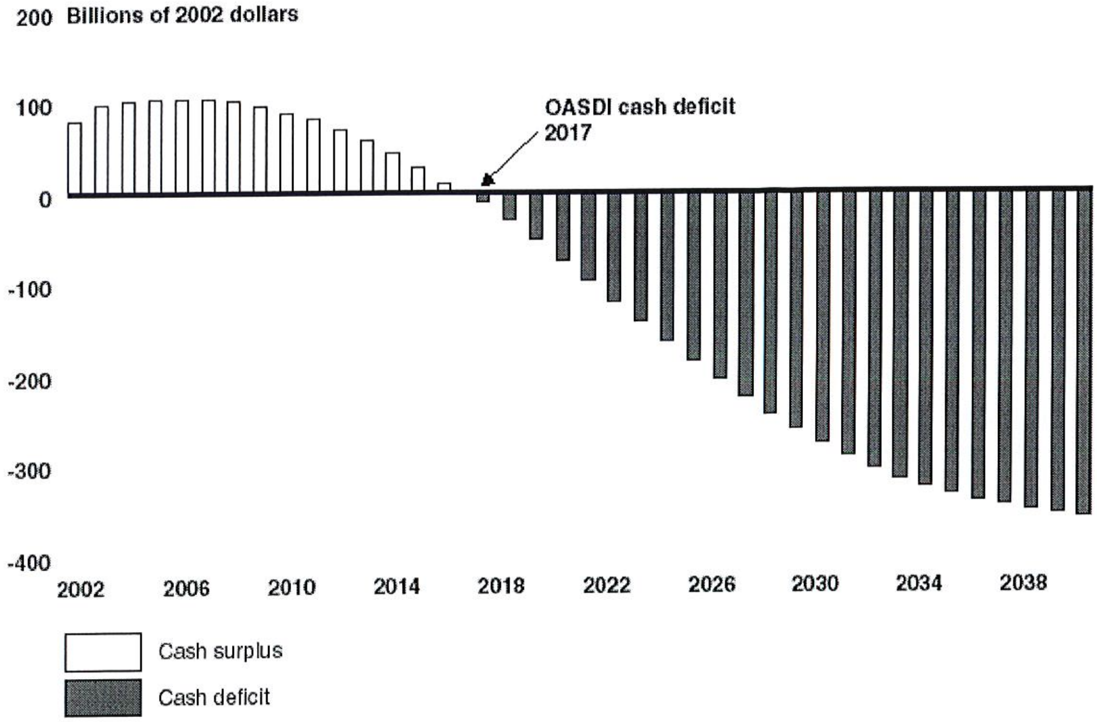
Specifications of Commission Reform Models

Personal Accounts	Model 1	Model 2	Model 3
Personal Account Size	2%	4% up to $1000 annually (indexed to wages each year)	1% new contribution plus 2.5% up to $1000 annually (indexed to wages each
Voluntary	Yes	Yes	Yes
Additional contributions required?	This is a generic 2% plan that can be done with or without contributions	None	1% of wages required to participate (subsidized through income tax
Real return that makes person better off with accounts than without (SS defined benefit offset rate)	3.5%	2.0%	2.5%
Accounts owned by participants?	Yes	Yes	Yes
Accounts can be bequeathed to heirs?	Yes	Yes	Yes
Participants can choose from a mix of low-cost, diversified portfolios?	Yes	Yes	Yes
Contributions and account earnings splitting in case of divorce?	Yes	Yes	Yes

Specifications of Commission Reform Models

Traditional Social Security Benefits	Model 1	Model 2	Model 3
New minimum benefit	None	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 120% of poverty level, inflation indexed.	By 2018, a 30-year minimum wage worker is guaranteed benefit equal to 100% of poverty level (111% for a 40-year worker), then rising with national wage growth.
Widow/Widower benefits	No changes	Increased to 75% of couple benefits (versus 50% to 67% today) for lower wage couples	Increased to 75% of couple benefits (versus 50% to 67% today) for lower wage couples
Changes to growth rate of traditional benefit for future retirees	None specified	Indexed to inflation instead of wages starting for those turning 62 in 2009.	Indexed to gains in average life expectancy (results in average annual growth of 0.5% over inflation)
Additional changes to traditional benefit formula	None specified	None specified	1. Reduce benefit for early retirement and increase benefit for late retirement 2. Gradually decrease bend point factor for highest income bend point from 15% to 10% starting in 2009

Figure 3: Social Security's Trust Funds Face Cash Deficits as Baby Boomers Retire



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration, based on the intermediate assumptions of the 2002 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

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