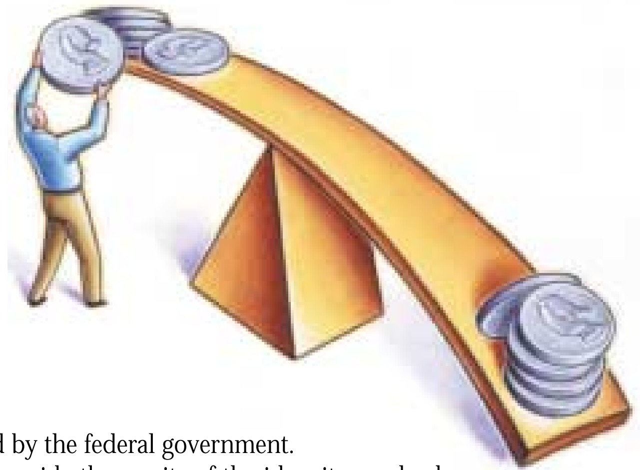
Commentary

By Stephen J. Hoeffner

Social Security Reform and the Private Pension System

The American public is at last beginning to focus on Social Security's long-term financial imbalance, but serious reform still seems as elusive as ever. While there's no shortage of "root canal" reform proposals—usually some combination of benefit cutbacks and payroll tax increases—none have made much political headway. Private Social Security investment accounts are touted by the political right as a painless reform, and criticized from the left as unworkable and contrary to the objectives of social insurance. But private accounts are eminently feasible and can be made to serve these social objectives. The key is to make creative and effective use of the existing private pension system.



At its inception in 1935, Social Security was designed to be advance-funded, but Sen. Arthur Vandenburg (R-Mich.) and others soon raised objections. Surplus payroll taxes, they thought, would be a drag on the economy. There weren't enough federal government debt instruments to absorb all the projected Social Security reserves, which could have led to significant government ownership of American businesses. In 1939, payroll taxes were frozen and benefits raised, which effectively converted Social Security to a pay-as-you-go system.

A growing American population has helped keep Social Security's pay-as-you-go financing in balance for 60 years, but now, with the huge postwar baby boom generation nearing retirement, demographics have at last turned against the system. To help take care of the boomers, significant advance funding has temporarily returned. With current surpluses of about $150 billion a year, Social Security will accumulate at least a $4 trillion trust fund by 2025. The fund then declines and is exhausted by about 2040, leaving at least a 25 percent pay-as-you-go shortfall. Unlike the 1930s, this time there are plenty of available U.S. Treasury bonds, in which all surplus funds are invested.

Reform Proposals

It's easy to see that the private equity investments Sen. Vandenburg feared in 1939 could help to shore up Social Security's finances today. President Clinton understands this and last year proposed investing roughly $500 billion in common stocks, to be selected and controlled by the federal government.

Leaving aside the merits of the idea, it was dead on arrival in the Republican Congress. Most Republicans enthusiastically endorse equity investments in private accounts, but President Clinton and congressional Democrats are rightly concerned that too much privatization would obliterate Social Security's redistributive benefit structure and burden less affluent Americans with unacceptable investment risk.

Private-account-reform legislation proposed by Rep. Bill Archer (R-Texas) and E. Clay Shaw (R-Fla.) deals with these concerns by forcing retirees to gradually pay their accounts over to the Social Security trust fund, from which they then receive monthly benefits computed under current law. Investment options would be very limited, and administration of the accounts would be closely supervised by a board appointed by the Social Security trustees. These are hardly "private accounts" at all, and the cost of administering 150 million of them has got to be prohibitive.

Recent political debates over anticipated federal budget surpluses have shown that Americans will support measures, such as paying down the national debt, that are perceived to financially benefit Social Security. But there seems to be little popular support for changes that are perceived as potential benefit reductions. (The only recent legislation—the earnings cap repeal—was a benefit increase.) Large-scale defined contribution-type Social Security reform won't be easy in this environment. All of this helps to explain the very limited nature of the Archer/Shaw proposal; it responds well to these political realities, but it's far from an ideal solution.

The Archer/Shaw proposal provides universal coverage, doesn't touch the existing Social Security bene-

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fit structure, and virtually eliminates any accountholder investment risk. Most important, anticipated equity investment returns don't generally increase an accountholder's total retirement income, but instead are channeled back to the system to help shore up its financing. What's missing is a way to minimize administrative costs and offer private accounts that are genuinely private—permanently and exclusively controlled by their individual owners.

Private pension system participation would minimize Social Security private account administrative costs, while well-established "floor offset" design techniques could accomplish the rest of these political objectives. The result could be a practical and politically feasible way to invest current Social Security surpluses in equities through private accounts.

One Approach

Here's one way all of this might work. First, a portion of current payroll taxes (perhaps initially 3 percent or 4 percent of pay up to the wage base, or some lower threshold) would be earmarked for individual accounts. The percentage would be selected and periodically changed to roughly match available financing. The process could extend over several decades but would not necessarily be permanent, continuing only for as long as there were annual Social Security surpluses or other financing sources.

Workers could direct their employers to either continue sending these earmarked taxes to Social Security or deposit them in an existing or newly established tax-qualified retirement account. The retirement account could be part of an employer-sponsored 401(k), profit-sharing or cash balance defined benefit pension plan, or a completely separate individual retirement account.

Earmarked payroll taxes for workers who declined the Social Security private account option (perhaps because they didn't have access to the private pension system) would be credited to individual notional accounts within the system that would function a lot like defined benefit pension plan cash balance accounts. These workers would likely see no change in their Social Security benefits but would have individual balances that could be transferred to private accounts at a later date, provided financing remained available.

Benefits for retirees who chose private accounts would be offset (reduced) by the monthly payments their private accounts could be expected to provide. The offsets would continue for the first five, 10, or 15 years after retirement. After that, the full Social Security benefit would be paid without any offset. Private Social Security account deposits could not be accessed prior to retirement age, and even then could be drawn down only gradually to supplement the net Social Security benefit. Residual accounts would pass to a worker's designated beneficiary (or

Some Examples

	INDEX RETURN: 6%		INDEX RETURN: 12%	
	RETIREE A	RETIREE B	RETIREE A	RETIREE B
Baseline Monthly Social Security Benefit	$ 1,500.00	$ 1,500.00	$ 1,500.00	$ 1,500.00
Benefit Offset Account	30,100.00	30,100.00	47,700.00	47,700.00
Monthly Social Security Benefit Offset*	250.83	250.83	397.50	397.50
Net Monthly Social Security Benefit	$ 1,249.17	$ 1,249.17	$ 1,102.5	$ 1,102.50
Private Account Balance	36,120.00	24,080.00	57,240.00	38,160.00
Maximum Drawdown*	301.00	200.67	477.00	318.00
Total Monthly Benefit	$ 1,550.17	$ 1,449.84	$ 1,579.50	$ 1,420.50

*Benefit Offset Account or Private Account Balance divided by 120 remaining months in offset period.

beneficiaries) at death.

To calculate a retiree's benefit offset, the Social Security Administration would first accumulate a hypothetical benefit offset account, reflecting all his or her annual private account deposits and annual "interest" credits tied to a hypothetical investment return index rate. The index rate would reflect the actual performance of a broadly based "capital marketbasket" of U.S. equities, reduced by a small margin for investment expenses and contingencies. In effect, the benefit offset account is roughly the amount retirees would have accumulated in their private accounts if their actual investments had mirrored the capital marketbasket reflected in the index.

In each year of retirement, the monthly offset to the Social Security benefit would simply be the remaining hypothetical benefit offset account divided by the number of months left in the offset period. Retirees would make up for the offset by drawing down their private accounts.

If their private accounts had outperformed the marketbasket index, their total combined income from Social Security and their private accounts would be larger than if they had declined the private account option. If their accounts failed to keep up with the index, they would receive less total income. (A third possibility—that offset accounts would grow sufficiently to cover the entire lifetime Social Security benefit—is unlikely given the expected level of available financing.

Some Examples

The chart above shows some examples assuming average 15-year capital marketbasket index returns of 6 percent and 12 percent, respectively. (That's 3 percent and 9 percent real returns, assuming a 3 percent rate of inflation.) In each case, Retiree A's private account performed relatively well and ultimately accumulated 20 percent more than the hypothetical benefit offset account, while Retiree B's account performed relatively poorly, accu-

mulating 20 percent less. The offset period, during which retirees would be expected to supplement their Social Security benefits by drawing down their private accounts, is 10 years. (All amounts shown are adjusted for inflation.)

As investment returns improved from 6 percent to 12 percent, the Social Security offset amount increased from $250.83 to $379.50. The result was a significant reduction in Social Security benefits from $1,249.17 to $1,102.50—a net savings to the system of $146.67 per month.

This result illustrates the power of private accounts, and this offset methodology, to dramatically improve Social Security's finances. If the earmarked payroll taxes paid by these retirees had simply earned a 6 percent annual return—as they might if invested in Treasury bonds—they would have financed only $250.83 per month. The additional $146.67 per month financed by their private accounts represents a genuine reduction in Social Security benefit obligations vs. current law.

While good capital market performance during the accumulation period significantly reduced the Social Security System's net benefit obligations, it had very little impact on the retirees' total monthly benefits. Retiree A received a bit more than his baseline $1,500 benefit under both the 6 percent and 12 percent return scenarios, while Retiree B received a bit less. The difference was due solely to the performance of their private accounts relative to the marketbasket index rate. These individuals assumed limited investment risks, and received limited rewards.

Meeting Design Objectives

Let's assess how well these private pension system design techniques helped meet our Social Security reform objectives.

■ **ADMINISTRATIVE COST.** Reasonable incremental cost for private account administration. Some additional cost from the Social Security Administration's perspective, but all in the defined benefit context, to which it's already accustomed.

■ **INDIVIDUAL BENEFIT/INVESTMENT RISK.** Very limited. All workers could, if they wished, insulate themselves from virtually all investment risk simply by investing in indexed mutual funds that mirrored the official capital marketbasket.

Only permanent advance funding could ever provide truly universal private account coverage

■ **SOCIAL SECURITY BENEFIT STRUCTURE.** Left completely intact. No matter what type of benefit is payable (retirement, disability, survivorship, etc.), the private account offset would be the same, with the recipient paid the net Social Security benefit.

■ **UNIVERSAL COVERAGE.** Not fully met. Workers whose employers don't offer qualified retirement plans, or whose accumulations are initially too small to make IRA investment administratively feasible, would initially receive only notional accounts within the Social Security system.

Private accounts need not be universal to gain political acceptance for several reasons. First, all workers would have some form of individual account, although not all would be private. Second, private accounts would usually not increase total expected benefits significantly. Third, earmarked payroll taxes would probably be relatively modest. (There's limited available financing, and it's politically important that all workers receive significant net Social Security benefits.) Finally, less affluent Americans, who would be least likely to have private accounts, are also the most dependent on Social Security, and would disproportionately benefit from any strengthening of Social Security's finances.

In reality, only permanent advance funding could ever provide truly universal private account coverage. Unfortunately, transition to any degree of permanent advance funding would probably mean either near-term benefit cutbacks or development of significant new financing sources. Earmarked private account contributions financed only by projected Social Security surpluses must eventually cease, leaving a system in which private accounts are essentially limited to workers born before a certain date.

Prospects for Reform

Real Social Security reform must be made with some degree of consensus. Private investment accounts such as I've described wouldn't go far enough for some privatization advocates. But any workable, politically feasible reform would be an enormous first step from their perspective—offering a place to invest, not just the projected Social Security trust fund but any available general revenue financing as well. If some of these advocates' financial projections are correct, the long-term result could be a universal, private, fully advance-funded pension system costing a fraction of the existing system.

Those who oppose all forms of privatization will see all private accounts as a threat to the Social Security system and the objectives of social insurance. But the primary objective of the approach I've described is to strengthen the financing of Social Security's existing benefit guarantees, not to change them, and certainly not to increase benefits for more affluent workers. In the final analysis, private accounts simply offer greater certainty of payment than the existing Social Security trust fund mechanism, with its uncertain reliance on future taxing authority and its inherent long-term political risks.

New concepts, such as Social Security notional accounts and essential actuarial indexing and annuitization techniques, will all take some getting used to. Economists, for their part, will debate the macroeconomic effects of every reform proposal. But if we're serious about modernizing Social Security to make benefits more secure for all American workers, private accounts that take advantage of existing private pension system administrative capabilities and design techniques should offer the best opportunity for reform. ●