DWIGHT K. BARTLETT III

Social Security and Medicare Reform Need a New Focus

A YEAR AGO, WITH CONTINUED ECONOMIC GROWTH and the appointment of a presidential commission, the prospects looked bright for a fundamental reform of Social Security and Medicare. Unfortunately, President Bush's marching orders to the commission circumscribed its considerations solely to individual retirement accounts, making a broader discussion virtually impossible.

In the May/June 2001 issue of *Contingencies*, Haeworth Robertson wrote a thoughtful piece, "Social Insurance Reform, Let's Just Do It," in which he argued that reform should be considered in the context of the objectives of our social insurance programs. He argued that certain measures used to evaluate the present programs, such as the "rate of return" achieved by individual Social Security participants on their taxes relative to the benefits they expect to receive, are ill conceived in light of the fundamental nature and objectives of the program.

I concur. I would also argue that the traditional focus on the projected trust fund balances and on the long-term balances between payroll tax rates and benefit costs are inadequate to arrive at judgments about the financial viability of the programs. Though these measures are useful for providing a disciplined environment in which to review the adequacy of annual financing of the programs, they tend to obscure the extent of general revenue financing involved, particularly Medicare Part B, which is not financed by payroll taxes.

A better measure of the present and long-range burden of the programs is their projected outgo as a percentage of Gross Domestic Product (GDP). According to the 2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance (OASDI) and Disability Insurance (DI) Trust Funds, the ratio for OASDI is 4.17 percent; for hospital insurance (HI) 1.35 percent, for a combined ratio of 5.52 percent.

These rise to 6.52 percent, 2.32 percent, and 8.84 percent by 2030, when the baby boomers are mostly retired. Including Medicare Part B (SMI) would raise the combined ratio to approximately 6.4 percent for 2001 and 12.0 percent for 2030. Even if program costs were to be pre-funded, benefits must come from the nation's productivity at the time they're provided. Many believe that 12 percent of GDP is an excessive burden for social insurance programs that are intended to be only a safety net and not the full support of our elderly dependent population.

DWIGHT K. BARTLETT III IS A CONSULTING ACTUARY WHO LIVES IN ANNAPOLIS, MD. HE WAS CHIEF ACTUARY FOR THE SOCIAL SECURITY ADMINISTRATION FROM 1979 TO1981.

JOHN CONROY

Traditionalists have proposed reforms that keep the programs as essentially pay-as-you-go. These include some combination of tax increases and benefit reductions for Social Security. Benefit reductions might involve further increases in the normal retirement age beyond the presently scheduled ultimate of 67, further refinement of the Consumer Price Index to more accurately reflect the increase in the cost of living, indexing wage records to cost-of-living increases rather than average wages, etc.

No one seems to be suggesting further payroll tax rate increases above the present level of 15.3 percent for employers and employees. However, some suggest raising the maximum taxable wage above its presently indexed level of $84,900 for 2002 for Social Security (HI already has an unlimited maximum).

To limit the extent of benefit reductions, however, it has been suggested that there be an increase in the level of general revenue financing for Social Security. That was a principal recommendation of the Clinton administration. Obviously that does nothing

to reduce the burden of our social insurance programs but merely disguises its true cost and undoubtedly redistributes the burden across various segments of the economy.

Benefit cost reductions for Medicare are more problematic. In the past, cost reductions have been achieved by reducing or at least slowing the increase in payments to Medicare health care providers. That approach has probably gone about as far as it can go.

Another approach is to encourage Medicare beneficiaries to enroll in local managed care programs as opposed to the traditional fee-for-service Medicare program. Enrollment in these programs has been limited. Not only is the traditional program, with its absence of restrictions on choice of providers and type of care, still popular, but managed care insurers continue to face mounting financial losses.

Pressures have been mounting for increasing rather than reducing Medicare benefits, including the addition of prescription drug coverage to the traditional Medicare program. For the time being, this concern appears to have eclipsed the concern about long-term-care needs of the elderly, now largely paid for by state-run Medicaid programs. But the rapid shift in the nation's demographic profile won't permit this aspect of the Medicare reform debate to remain on the back burner for very long.

The pay-as-you-go nature of the programs makes them prone to what some see as intergenerational inequities; some generations receive more benefits in relation to their lifetime payroll taxes than others. That was most obviously true for the first generation to receive benefits, and was well understood by the original designers of the program. What was not anticipated was the large swings in the size of generations, from the Depression-era-babies, the baby boom generation of 1946 to 1964, and the following baby bust generation. These generational waves and troughs dramatically affect the periodic ratio of program beneficiaries to working taxpayers, roughly 1 to 3 at present but scheduled to be in the 1 to 2 range when the baby boom generation is fully retired.

1/2
House Ad
Page 12

All these problems have given rise to the notion that advance funding of future benefits is the best reform proposal, particularly individual accounts for Social Security. Assuming program reform doesn't involve benefit reductions, advance funding of Social Security will reduce the program's ultimate burden only if it results in a more rapid growth in the nation's GDP. And that growth will occur only if the allocation of the current GDP between consumption and savings (i.e., capital formation) swings more toward the latter. That, in turn, assumes that workers with individual Social Security accounts are willing to reduce their current consumption rather than simply reducing other forms of savings.

That, in my opinion, is a highly questionable assumption. But it's worth studying, given the importance of the issue.

More Risks

Furthermore, Social Security benefit formulas are based on a balancing of individual equity and social adequacy. The latter objective is reflected in the bend points in the formula for calculating a worker's primary insurance amount (PIA), which results in a lower replacement ratio for workers with higher indexed covered wages. Also, workers with eligible dependents receive higher benefits without regard to their contributions.

Benefits that become ultimately payable from a worker's individual account will presumably be calculated on an actuarially based conversion of the accounts balance to a monthly income, without regard to past wage levels and family situation. In other words, the benefits will be based entirely on individual equity without regard to social adequacy concerns. The remnant of the program

that will continue on a pay-as-you-go basis will presumably retain a substantial social adequacy component, but when the program is taken as a whole there will be a significant swing away from social adequacy to individual equity, unless . . . .

That "unless" presents another substantial danger of this type of reform. In order to preserve the social adequacy element of the present program, which has broad public support, it may be necessary to provide guarantees. For example, no beneficiaries will receive less in benefits than they would receive under the present program. That sounds like Garrison Keillor's description of Lake Wobegon as a place where "all the children are above average." It's logically impossible to do without substantially increasing the average and thus the total cost of the program—which negates the intent of reform.

Twenty years ago, President Jimmy Carter appointed a Commission on Pension Policy. The commission's principal recommendation was that employers be required to adopt pension plans for their employees. The minimum acceptable plan would be a defined contribution program with a minimum 3 percent of salary contribution by the employer. This recommended mandatory universal pension system (MUPS) was dead on arrival, partly no doubt due to the subsequent change of administration. Congress has continued to rely on the more traditional approach of providing tax incentives to encourage the voluntary adoption of pension and savings programs.

If the judgment of that time was correct that MUPS was a bad idea, its new incarnation as individual accounts under Social Security seems to be a far worse idea today. In addition to all the concerns expressed above, it ignores what's been happening to private pensions and savings programs.

Perhaps because of what some argue is the burdensome regulation of defined benefit (DB) plans, there has been a dramatic swing over the past several decades from defined benefit plans to defined contribution (DC) plans. According to the Employee Benefit Research Institute (EBRI), the percentage of private sector employees' participation in defined benefit plans has declined from nearly 40 percent to less than 25 percent, while participation in primary defined contribution plans has increased from 7 percent to nearly 25 percent.

There has also been an enormous growth of participation in secondary voluntary savings programs such as 401(k) plans, 403(b) plans, and individual retirement accounts. EBRI research shows that by the end of 2000, there were 42 million 401(k) participants holding accounts with $1.8 trillion in assets.

DB plans incorporate elements of social adequacy, albeit not to the extent of Social Security. They reflect, for example, a socialization of cost, i.e., the benefits projected to be paid to individual employees are not tied directly to the contributions made by the employer for that employee.

DC plans and voluntary savings programs, on the other hand, provide benefits to participants directly linked to their account balance, which in turn is a result of the contributions to their accounts and the associated investment income. Benefits under DB plans are also paid to retirees without regard to the investment performance of the underlying assets; the plan sponsor is responsible for making up any funding shortfall due to poor investment performance. Participants under DC plans bear the full investment risk.

This enormous decline of DB plans, which have at least a modicum of concern for social adequacy, strongly reinforces the need to protect the social adequacy elements of Social Security without simultaneously increasing the cost of the program. Social Security and Medicare reform needs to keep their costs at a sustainable level in relation to our GDP, but we shouldn't be misled by false and unproven claims of the efficacy of individual retirement accounts. ●

1/2
Chicago Consulting
Page 14