Remaking Social Security From the Ground Up

BY LINDA MALLON

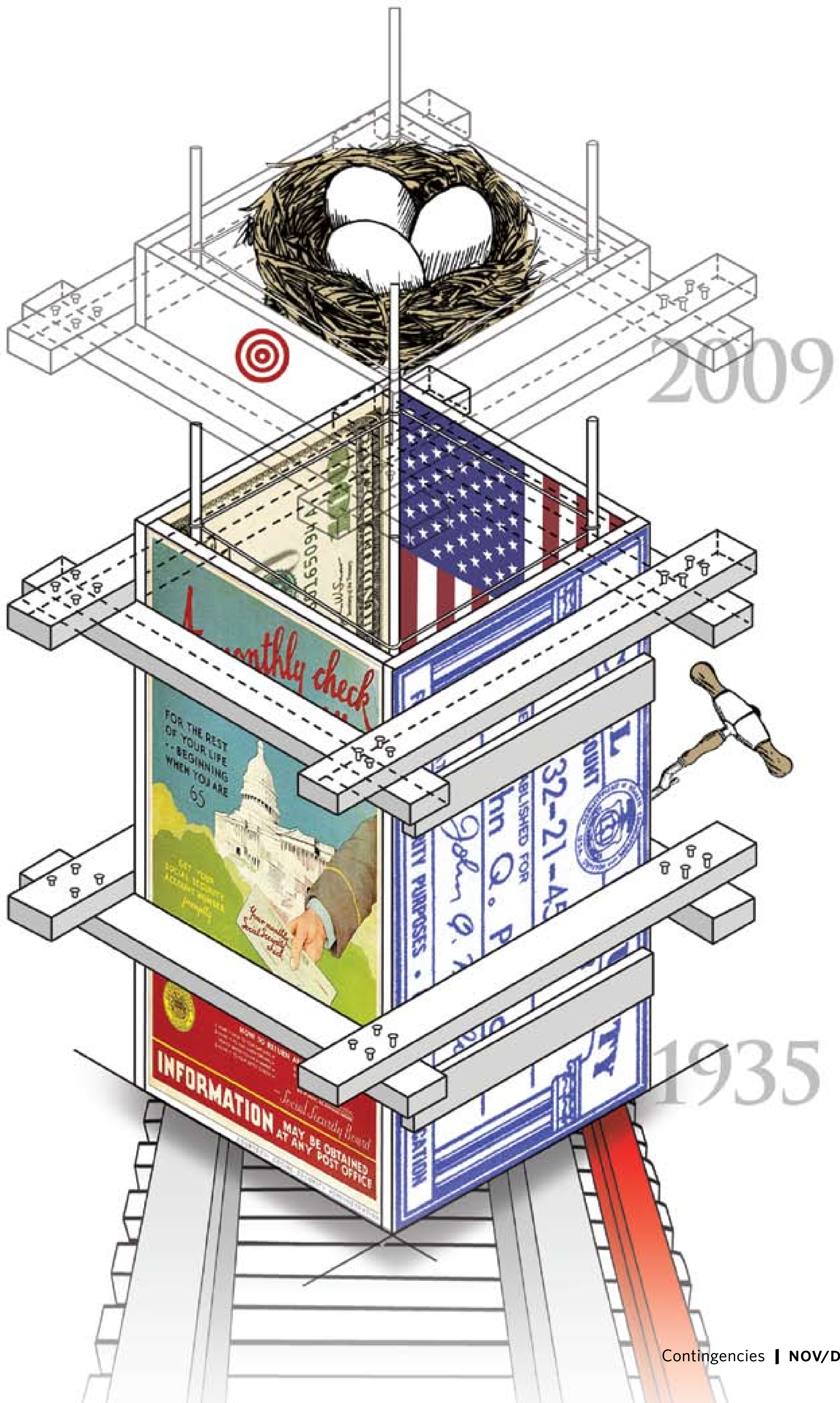
We asked four pension actuaries, knowing what they know today, to redesign Social Security from scratch. Here's what they came up with.

FROM THE MOMENT OF ITS 1935 ENACTMENT in the depths of the Great Depression, Social Security has been subject to revision. Beginning as early as 1939 and continuing to the present, the nation's largest social insurance program (and, by dollars paid, the largest government program in the world) has been tweaked, fine-tuned, amended, and adjusted. Proposals to reform Social Security have roiled the policy waters (and, occasionally, political fortunes) of every president from Gerald Ford through to George W. Bush. It's no shock (so to speak) that Social Security is frequently called the third rail of American politics.

Actuaries, who helped to design the system, have always played an important role in keeping Social Security on track and financially sound. They feel strongly about the positive impact that Social Security has had on the welfare of all Americans and equally strongly about the profession's ongoing role advising policymakers on the system's long-term financial soundness. Just this summer, when the Academy released its first public interest statement advocating for a specific public policy position, it was no surprise that the subject was Social Security—specifically the profession's contention that because of increasing longevity, Social Security's retirement age should be raised.

In light of this year's presidential election and the near certainty that Social Security reform will be an early priority of whichever candidate wins, I thought it would be interesting to step back and take a fresh look at the how Social Security is structured. Earlier in the year, I issued the following challenge to several pension actuaries who I knew had a special interest in the program: Knowing what you know today, how would you redesign Social Security if you had to do it all over again from scratch? Four brave souls, Tom Terry, Anna Rappaport, Ken Buffin, and A. Haeworth Robertson, accepted my challenge, and their answers are printed on the following pages. They worked independently, but not surprisingly, there are many similarities in the plans that they present. Most strikingly, however, nobody advocated just blowing up the current program.

It's pretty clear to all concerned that there is a lot worth saving in the grand old system.



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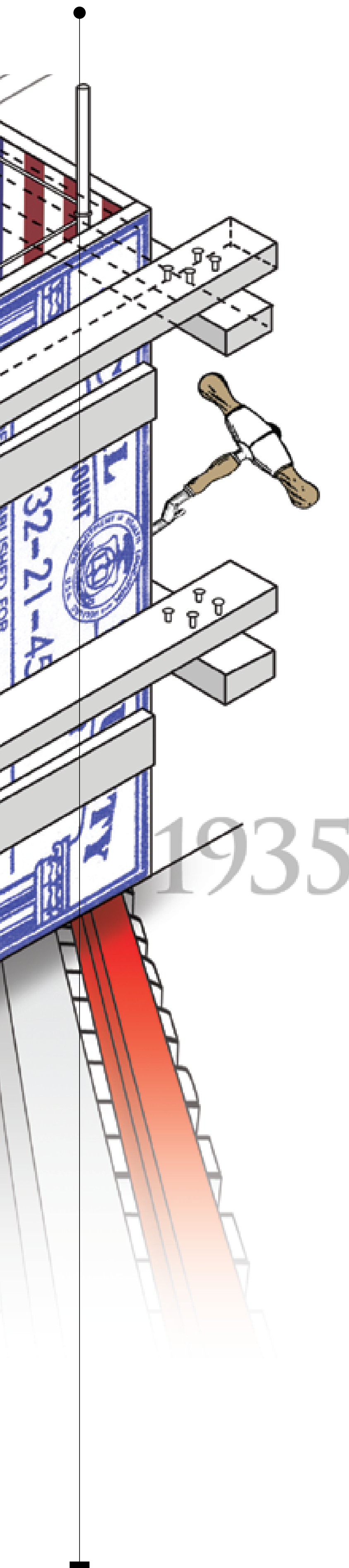

Periodic Adjustments Will Keep a Great Program on Track

BY THOMAS S. TERRY

FRANKLIN DELANO ROOSEVELT supposedly considered Aug.14, 1935—when he signed Social Security into existence—the most important day of his administration. For months, he had negotiated political battles and intense maneuvering to finally build consensus for a sweeping piece of legislation.

After signing the Social Security Act, though, Roosevelt faced more years of wrangling. The first calls to reform Social Security started in 1936. The first amendments were added in 1939. By the time Social Security began paying out monthly benefits in January 1940, it had already evolved within FDR's original framework.

Nearly 75 years later, Social Security is regarded as the most successful social insurance program ever. For close to three generations, it has provided millions of retired Americans with a basic level of financial protection. Social Security has stood the test of time because it's founded on some sound premises. One is the idea of mutuality. In Social Security, America becomes one giant community, pooling its resources and risks to meet the needs of particularly vulnerable members. Another is the simplicity of its inherent financing mechanism: Dedicated payroll dollars flow in, and benefits flow out. From day one, the system was designed to be pay-as-you-go. Without that fundamental financing mechanism, decades would have passed before Social Security could have paid benefits of any real substance.

This fundamental social contract can continue. It works. Nevertheless, nearly every decade since the 1930s has seen intense debate about program direction when all that was warranted was an informed conversation about the adjustments needed to keep the program on track. In each case, significant congressional turmoil has been required to alter coverage, respond to inflation, recover from over-engineering, and so on.

There's logic in adapting a social program as a society evolves. Societies are dynamic. Birthrates rise and fall, as do immigration rates. We've also seen dramatic increases in longevity. Many believe these increases will continue.

Yet in this country, every time we acknowledge that Social Security requires adjustment, public hand-wringing and dramatic calls for overhaul ensue. And, after a solution has been finally hammered out, we act as if the issue is handled once and for all. A collective amnesia takes over.

Rather than lurching from crisis to crisis, we should recognize the ongoing need to adjust Social Security. Further, we could institutionalize ongoing course corrections so that they are no longer so reactive, partisan, or ponderous. Given Social Security's status as the "third rail in American politics" (that is, to touch it is to die), Congress understandably puts off taking corrective measures until the system is facing deep difficulty. Yet waiting until we are in the weeds limits options and stymies creative thinking. In other words, it's harder to design a good sprinkler system when the house is already burning.

A better approach to periodic Social Security reform would be to establish an agreed-upon system of early-warning indicators—and the actuarial profession is in position to play a leading role in this effort. Each year, the Social Security Trustees report on the program's status and prospects. The actuarial profession could build on these annual findings to propose elements for needed change. As an example, this past summer, the American Academy of Actuaries encouraged raising the retirement age as part of restoring the long-term balance between tax revenues and retirement benefits. In speaking out on these issues as a profession, we can use our expertise to support the system in generating the greatest good for the greatest number.

Indeed, I think we miss an enormous opportunity as a profession if we take a limited view of the current discussion on raising retirement age. This is not an isolated issue but an aspect of a larger process. Before us is the chance not just to tweak one program feature but to engage in devising a system that fluidly and equitably addresses the megatrends of inflation, shifting work patterns, changes in birthrates or longevity, changes in immigration rates, pandemics, and other health crises as they emerge.

Given that risks never go away—and indeed,

if they did, there would be no call for Social Security—we need a program designed to absorb shocks, respond appropriately, and continue delivering benefits without congressional paroxysms. I don't think our mission is to stretch Social Security so that it compensates for the growth or demise of corporate pension plans, changes in savings rates, or a shifting view of Social Security's role versus other retirement security devices. But I do think we can take a stand for devising a more efficient system of change. Such a system would head off the calls for privatization, which in my view is a solution to a problem that doesn't exist.

Social Security isn't broken; it just needs to keep evolving with society. ●

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Targeted Reforms That Reflect New Societal Norms

BY ANNA RAPPAPORT

SOCIAL SECURITY HAS MADE a major contribution to the welfare of many families and the security of older Americans. There are things I very much like about the system and things that I believe should have been designed or should operate differently. What I like about the current system is easily summed up:

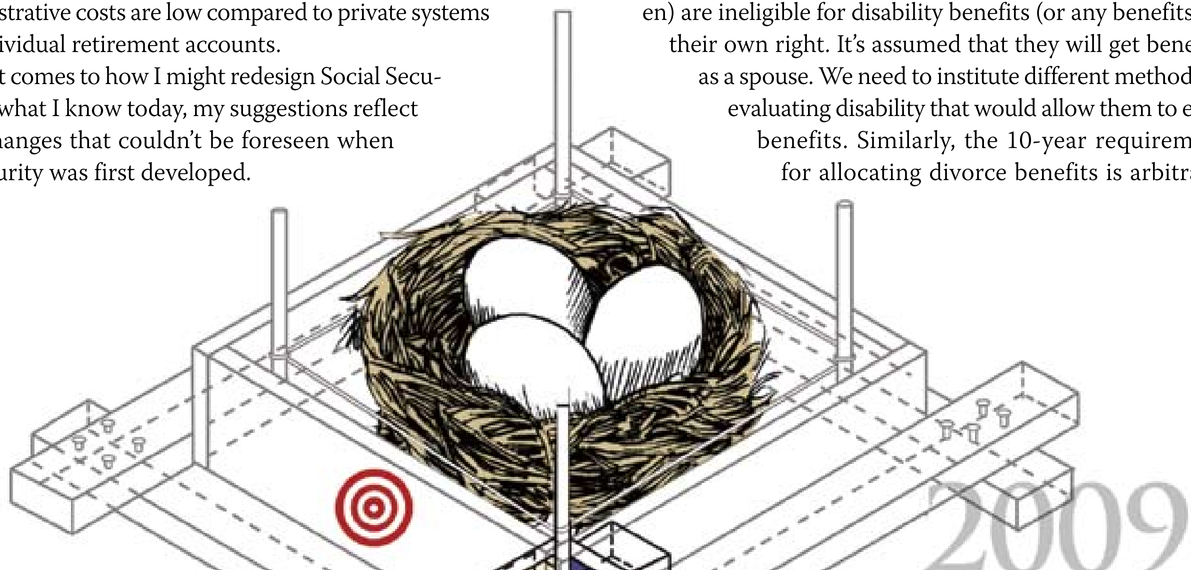
- Participation is nearly universal, generally mandatory, and an individual doesn't need to make choices until retirement;
- Benefits are paid out as lifetime income;
- Benefits are redistributive and are relatively higher for those with lower earnings;
- The system provides survivor and disability benefits;
- The system is paid for by earmarked contributions;
- Benefits are indexed for post-retirement inflation and pre-retirement changes in wage levels;
- The system supports phased retirement, at least to some extent;
- Administrative costs are low compared to private systems and individual retirement accounts.

When it comes to how I might redesign Social Security, given what I know today, my suggestions reflect societal changes that couldn't be foreseen when Social Security was first developed.

Currently, the eligible age for collecting Social Security benefits is fixed by law and can be adjusted only by legislation. But life spans have increased significantly since the 1930s. I would index retirement eligibility to increases in longevity. Had this been done at the beginning, current retirement age would be much higher and the system in stronger financial shape. Indexing the retirement age also creates the expectation that it will naturally increase over time.

Social Security benefits are designed to fit the single-earner traditional family but don't work well for dual-income families. The problem is particularly difficult for spouses with equal earnings. In that case, the death benefit after one dies is half of the total benefit for the couple, compared with two-thirds for single-earner families.

At the same time, those who don't work in the paid labor force but provide unpaid work in a household (usually women) are ineligible for disability benefits (or any benefits) in their own right. It's assumed that they will get benefits as a spouse. We need to institute different methods of evaluating disability that would allow them to earn benefits. Similarly, the 10-year requirement for allocating divorce benefits is arbitrary.



Matching the benefit of a divorced spouse with that of a married spouse seems illogical in a society where alimony is rare and divorce may have occurred years earlier. A benefit that increases on the death of a prior spouse who isn't paying alimony makes no sense.

In light of evolving family patterns, I see three options:

- Earnings-sharing;
- Reducing the spousal benefit to one-third of the worker benefit and increasing it after the larger earner dies to two-thirds of the couple's combined benefits;
- Providing a flat base benefit that is not tied to earnings and supplementing it with a second-tier benefit tied to earnings.

I would advocate restructuring Social Security to provide a flat minimum benefit. A second tier that is earnings-related could be offered on the top of the minimum benefit. For the second tier, earnings- or credit-sharing would apply to a couple's income but only in years when they are married. If earnings-sharing is adopted, then disability benefits would need to be redefined and not linked directly to the retirement benefit.

At the time Social Security was created, some Americans weren't included. I would include everyone. This would be particularly important if part of the system is a flat benefit.

Finally, I believe that better public information is vital. For many Americans, the decision about when to retire and when to start collecting benefits can have a huge impact on their welfare later in life. Monthly benefits for those who retire at age 70 can be nearly twice as large as for those who retire at age 62. I think we need to beef up public education to help people understand and evaluate their choices about when to receive benefits. Even if retirement ages were indexed, there would probably still be a range of possible retirement ages. Similarly, many people who are dissatisfied or lack confidence in the system don't understand how it works (or is intended to work).

Often the discussion of Social Security reform is focused on the financing without an analysis and presentation of whose benefits will be affected and by how much. We should remember that about 40 percent of older women get virtually all of their income from Social Security and that for many others, Social Security is their largest source of retirement income. Every discussion of reform must balance financial impact with a presentation of how benefits will be affected and for whom. We need to analyze a broad sample of situations, taking into consideration what groups will be affected and by how much.

Because they live longer and have, on average, lower pension benefits based on different earning histories, women are more dependent on Social Security. They are also most likely to be alone and poor (or near poor) in old age. The needs of women should not be forgotten in the range of situations studied. ●

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A Three-Tiered System Anchored by a Universal Benefit

BY KEN BUFFIN

AN ACTUARY ASKED TO DESIGN THE ORIGINAL Social Security system, but with the benefit of a detailed knowledge of events that would occur over the next three-quarters of a century, would undoubtedly design a system that differs in significant ways from our current Social Security system, which has evolved gradually over the years. The specifications for coverage, benefit amounts, and funding arrangements would be quite different.

If I were that actuary, I'd propose a three-tiered national retirement system that would provide a universal basic benefit for all eligible persons in the first tier; the second-tier benefit would be based on active participation in the workforce and national average earnings; the third tier would provide supplemental voluntary national savings and retirement accounts with tax-deferred incentives.

With respect to coverage, the principle of universality would apply; all U.S. persons, whether or not they are employed (either in the formal or informal workforce sector) or are classified as lifetime poor, would be entitled to a basic subsistence-level first-tier old-age monthly income benefit. This benefit wouldn't be means-tested and would be payable to all individuals without regard to marital or family status or living arrangements. Entitlement to this first-tier benefit would require a minimum residency period in the U.S. and would be similar to the New Zealand Superannuation system in terms of its design and administration. In today's environment, the first-tier monthly benefit for old-age income support would be approximately $400 and would be determined for each calendar year as 1 percent of the latest national average annual wage index amount.

The first tier of the Social Security system would be supported by general revenues of the federal government. There would be no payroll taxes and no separate trust fund. General revenue sources would include income taxes, a national value-added consumption tax, and corporate taxes. The funding for the first tier would be entirely on a pay-as-you-go basis.

The second tier of the system would be structured as a defined benefit system. Benefits would be payable on meeting

specific eligibility requirements for old-age, disability, and survivorship that are broadly similar to the corresponding provisions of today's old-age, survivors, and disability insurance (OASDI) component of Social Security. This employment-related second tier would provide benefits based on participation in the national workforce. A uniform benefit for all employed persons would be provided, based on a formula consisting of two elements: years of participation in the workforce and the national average earnings level. The monthly normal retirement benefit formula would be 1 percent of national average monthly earnings multiplied by the number of years of workforce participation up to a maximum of 40 years.

The second tier of the system would be funded by means of a National Workforce Pension Fund (NWFPF) based on 75-year actuarial projection methodology with the annual funding requirement expressed as a level percentage of gross domestic product. The annual funding requirement would be met from general revenues of the federal government and invested in the fund. The NWFPF would be administered by an independent board with an investment mandate that would include a broad range of asset classes, including equities and real estate. No part of the fund would be available for use by the federal government, and there would be specific prohibitions against investing in any kind of government securities and against lending to the federal government for any purpose. The principal source of funding for this second tier of the Social Security system would be reflected in a restructuring of the corporate tax system and would place a clear responsibility on corporate America for the adequate funding of workers' old-age income support on an aggregate macroeconomic basis.

The third tier of the Social Security system would be designed to encourage individuals to take responsibility for making adequate supplemental provision for their own economic security by means of a national savings and investment program. Participation would be entirely voluntary; all contributions and investment income and capital gains would be tax-deferred until the commencement of any benefit payout. There would be a central National Savings and Investment Fund (NSIF) comprising several choices of investment strategies that reflect various asset class allocations and risk profiles. Individual account balances within the NSIF would be available for use for supplemental old-age income provision by annuitization; account balances would also be available as a source of funding for home purchase or for family education expenses such as college tuition. ●

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Philosophical Basics Undergird Revised Model

BY A. HAEWORTH ROBERTSON

WHEN THE FEDERAL GOVERNMENT considers some sort of social insurance program to help replace a portion of earned income lost when a person is unable to work because of old age, disability, or death, the program's design should be consistent with an explicitly stated philosophy. What works for a particular country and its unique social and economic culture isn't necessarily suitable for another country.

For an American program, I would suggest the following principles as a guideline for determining the government's role:

- Individuals should have freedom of choice to the fullest extent possible consistent with the interest of the nation as a whole.
- Individuals should be afforded maximum opportunity and incentive to develop and utilize their abilities throughout their lifetimes.
- Government—federal, state, or local—should provide only those benefits that individuals cannot provide for themselves (acting alone or as part of a group in some form of voluntary pooling or risk-sharing arrangement). In the process, government should become involved to the least extent possible consistent with the interest of the nation as a whole.

Remember that the government doesn't have any money to give us except what we ourselves have paid in taxes. When we demand a benefit from the government, we are demanding it from our fellow citizens—our friends and neighbors as well as people we've never met. The government is simply a system we've established and a group of people we've hired or elected to carry out our wishes.

There are several economic risks that individuals will find difficult to protect against—risks that may justify government intervention in the form of requiring taxpayers to give up something for the

benefit of those in need:

- ► Unbridled inflation at a time when an individual doesn't have the protections normally afforded an active wage earner; that is, when he or she cannot work because of old age or disability.
- ► Unpredictable abnormally long life spans as a result of breakthroughs in health care, including improved public health services.
- ► Misfortune, financial or health-related, that isn't reasonably controllable by the individual.

Were it not for these risks, an individual could—in theory, at least—make adequate provision for virtually every mishap that might befall him or his family by simply:

- ► Analyzing the risks to be protected against (old age, disability, death, or illness).
- ► Setting aside a sufficient amount from current earnings to provide for these risks, either in the form of personal savings or through the purchase of insurance or annuities.
- ► Relying upon extended family for support.

Still, there will be cases in which individuals must look to the broader community (i.e., the government) for assistance. But in designing such assistance, it's important to strike the right balance between providing benefits for the truly needy and maintaining an environment that encourages creativity and self-sufficiency—and thus a desirable level of national productivity and development. Benefits that are too generous will eventually create unnecessary dependence on—and even presumed entitlement to—the fruits of others' labor. This sense of entitlement is strengthened if taxpayers are falsely led to believe that their taxes are being saved to provide for their own future benefits, rather than immediately redistributed to others.

Those who are deprived of enjoying all the fruits of their labor tend to produce less fruit. Yet benefits that are too niggardly can result in societal unrest and breakdown. This is a dilemma that cannot be resolved by relying on good intentions alone. Rather, it requires clearheaded analysis, keeping in mind long-range consequences as well as short-range expediencies.

Had I been asked in 1932 to create such a social insurance program, I would have proposed the following. It's called the Freedom Plan and consists of three parts:

1. **Mandatory Senior Citizen Benefit Program**—At age 70, a monthly uniform lifetime benefit would be payable to each resident citizen of the country, regardless of previous employment, earnings history, marital status, financial need, gender, or any other factor. Residency for at least 25 years during the period from age 35 to age 70 would be required.

   Benefits would be set at approximately the subsistence level and could be related to the average earnings of all workers, the average national industrial wage, or perhaps the minimum wage; and would be adjusted periodically as the relevant index changed. If substantial differences in the cost of living in various regions of the country persist, the amount of the benefit could vary with the geographical area of residence during retirement. The benefit would not be subject to federal income tax.

   The age at which benefits are paid would be adjusted based on the general health of the elderly and their longevity, as well as other factors. This age would be determined at least 25 years in advance to permit rational retirement planning (from 1932 to the present day, this age would have climbed from 70 to about 75, and could be expected to rise to about 80 by 2050).

   The benefit would be financed on a current-cost basis, with some form of general revenue taxes collected annually to pay benefits for that year. Because of my program's Depression-era beginning, some level of deficit financing would be necessary in the early years as the program phased in.
2. **Disability Benefit Program**—A program similar to the senior citizen benefit program but with suitable modifications in the age and residency requirements.
3. **Freedom Bond Program**—Intended to provide a minimum standard of living, the senior citizen benefit requires everyone neither to work until age 70 nor to keep to a minimum standard of living. People can retire whenever they please, on any standard of living their thrift or good fortune will support. Because in 1932 there were relatively few reliable investment channels for investing and saving for the future, I would have proposed that the government offer retirement saving Freedom Bonds as a mechanism for individual retirement saving, with the following general conditions:

- ► The bonds could be purchased by any resident citizen between ages 30 and 70.
- ► The maximum amount of bonds purchased by someone in a given year would be 10 percent of his taxable earnings in the prior year; but any eligible individual could purchase such bonds, regardless of earnings, in an amount equal to 10 percent of average earnings of the nation's employees for the prior year.
- ► Each year, the value of bonds purchased in a prior year would be adjusted to reflect changes in the relative purchasing power that had occurred between the purchase and current valuation dates. Interest earnings of 2 percent of the bonds' current value would be earned and applied to purchase additional bonds.

My Freedom Plan would satisfy the essential income security needs of our nation's citizens within an environment affording maximum freedom of choice. Individuals would continue to be primarily responsible for their and their family's economic needs but with a safety net sponsored by fellow citizens. The Freedom Bond program would provide an opportunity to supplement this minimum floor of protection with savings and investments. ●

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