

A Framework for Analyzing and Comparing Social Security Policies

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Issue Brief

- This *Issue Brief* provides a framework for evaluating and comparing Social Security policies by delineating 11 broad areas of consideration and highlighting some of the relevant questions within these areas. This framework is not a comprehensive list of all considerations but is intended to provide a feel for their complexity and to highlight some of their most popularly recognized interactive possibilities. As the first report to be delivered in the course of EBRI's Social Security Reform Analysis Project, this *Issue Brief* sets the theoretical framework in which to place the forthcoming technical results from the EBRI/SSASIM2 Policy Simulation Model.
- Sound outcome comparison and analysis defies cursory examination and is a multifaceted process. The interplay between complex beliefs and values involved is testimony to the potential shortcomings of any proposed "easy answers" to the resolution of Social Security's finance issues. As this framework shows, in fair and comprehensive comparison and analysis, every Social Security policy reform, as well as the current system, must be held accountable to a number of hard questions.
- There are three broad areas to consider in comparing Social Security policies. The first is identification of the policies' underlying philosophies and assumptions that affect policy goals. Second, the nuts-and-bolts structure of each policy must be ascertained. Knowing the specific parameters of a plan provides a starting point for predicting programmatic outcomes, the third broad area of consideration.
- Here is where "the basics" end and complexity begins. For the purposes of Social Security debate, there are 11 broad policy outcome considerations: (1) adequacy, (2) equity, (3) monetary costs, (4) other economic effects, (5) effects on the rest of the U.S. retirement system, (6) governmental effects, (7) administrative effects, (8) political effects, (9) social effects (or, nonmonetary cost considerations), (10) protection against uncertainties, and, finally, (11) the determination of the best policy by weighing each of the aforementioned considerations.
- These outcomes must be identified in terms of three key aspects: each outcome's effect on all demographic groups potentially affected, potential short-term and long-term interactions among outcomes, and the rationale behind each outcome prediction. The four points of consideration for outcome prediction rationale are: assumptions used, validity of assumptions, sensitivity of outcomes to assumptions, and robustness of these assumptions over time.
- Finally, differing ideas about the appropriate goals of Social Security policy emerge from varying underlying assumptions about political, economic, and other human behaviors. In addition, policy advocates differ in their assumptions about demographics and their views of desirable public policy goals, including beliefs about the appropriate delegation of responsibility between government and workers in providing retirement income security.

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OASDI's Finance Issues

Under current law, the Social Security program will meet the retirement of the baby

boom generation¹ in 2008, when the first boomers reach eligibility for early retirement benefits at age 62. This retirement wave will only exacerbate pre-existing demographic pressures, primarily the result of our aging society, maturing social insurance systems, and lower birth rates in cohorts succeeding the baby boom generation. In 1983, policymakers anticipated this long-range demo-

graphic strain by increasing the normal retirement age (NRA) and by raising Social Security taxes. Recalculating tax rates, policymakers averaged the combined Old-Age, Survivors and Disability Insurance (OASDI) program's cost as a percentage of taxable payroll over a 75-year projection period, resulting in a tax rate higher than needed to fund short-term obligations.

In effect, this method of calculating the OASDI portion of FICA added a partial advance funding structure to the Social Security system that went beyond the historical practice of simply maintaining a contingency reserve. Due to the fact that, since 1983, FICA taxes have been higher than needed to meet current benefit payments, "surplus" Social Security revenue has been accumulated. This revenue has been converted into Special-Issue Treasury bonds and credited to the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds, which are maintained by the Social Security Administration. By the end of 1996, the OASDI trust funds had accumulated approximately \$566 billion in assets, an amount anticipated to peak at about \$1.3 trillion (in 1996 dollars) by the year 2015.²

Theoretically, the Social Security trust fund surplus will be drawn down as demographic pressures mount, helping younger workers pay for Social Security retiree benefits and thereby keeping future FICA taxes lower than they would be if the system were maintained on a purely pay-as-you-go³ basis.⁴ Under intermediate assumptions, interest income from the OASDI trust funds will begin to be used to finance the portion of Social Security benefits obligations not funded by

¹ Persons born between 1946 and 1964.

² See Board of Trustees, 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, DC: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, 1996). The trust funds held about 13 months of Old-Age, Survivors and Disability Insurance (OASDI) benefits in reserve at the end of 1996. Under intermediate assumptions, the trust fund is expected to peak with holdings of about 25 months worth of benefits by the end of 2005. Under the same assumptions, the trust fund is projected to hold about 13 months of benefits in reserve by 2015.

REASONS FOR CHANGING TRUST FUND BALANCES, 1983-1996

75 Year Actuarial Balance in 1983 OASDI^a Trustees' report = +0.02
 75 Year Actuarial Balance in 1996 OASDI^a Trustees' report = -2.17
 (as a percent of taxable payroll) Change in Balance = -2.19

Reason for -2.19 Change in Actuarial Balance	Amount and Direction of Change
Legislation	+0.10
Valuation Period	-0.55
Economic Assumptions	-0.79
Demographic Assumptions	+0.83
Disability Assumptions	-0.70
Methods	-0.93
All Other	-0.15

Source: Office of the Actuary, Social Security Administration, 1997.

^aOld-Age, Survivors and Disability Insurance.

current FICA taxes in 2012.

Principal from the trust funds will begin to be used in 2019. In the absence of

reform, the 1996 Social Security Trustees' report estimates that the trust funds will be depleted in 2029, under intermediate assumptions. At that time, FICA revenues alone will be able to finance only about three-fourths of benefit obligations for the remainder of the 75-year projection period (2029 through 2070).

Few among the general American public realize that trust fund balances are dwindling by legislative design, and, therefore, **falling trust fund balances are not "news."** The real news about the trust funds is that they were not expected to dwindle as quickly as current projections predict. After passage of the Social Security Amendments Act of 1983, the 1983 Social Security Trustees' report projected that the trust funds would hold 54 percent of outlays in reserve by 2060 under the second set of intermediate assumptions (Board of Trustees, 1983). In contrast, intermediate assumptions used in the 1996 Social Security Trustees' report project the OASDI trust fund balance to be exhausted by 2029.

Although legislative changes from 1983 to 1995 and more optimistic demographic assumptions had positive implications for the combined OASDI trust fund balances, these were outweighed by other factors. **The markedly more negative projections in the OASDI Trustees' reports from 1983 to 1996 are attribut-**

able to use of stricter actuarial methodology in calculating trust fund balances, a change to

more pessimistic disability and economic assumptions, and other changes.⁵ An additional contributing factor is that the period projected in the 1996 report includes 12 deficit years in which demographic pressures will be strong (see table above).

Because, as a whole, the 1983 Trustees' assumptions are optimistic in retrospect, some are concerned that 1996 Trustees' projections are optimistic as well and are therefore understating the OASDI long-range financial shortfall.⁶

In addition, **critics of the current system argue that the trust funds are already essentially depleted** because their assets are borrowed by the federal government (i.e., Congress), which uses them to finance other government operations. When the OASDI program's Treasury bonds must be redeemed in order to pay benefits, the only way for the government to repay its loans will be to borrow money from other sources, increase general taxes, or reduce other areas of government spending. In any case, assuming that trust fund assets will need to be tapped in order to pay benefits, general tax revenues are likely to rise. This leads many to speculate that the combined OASDI trust fund "isn't really there" in the sense that the money current workers are paying today in excess of current benefit

³ A pay-as-you-go system is one in which all FICA taxes collected today are used to pay for all Social Security benefits due today. That is, in a pay-as-you-go system, the only money used to pay current benefits is money collected from current workers' wages.

⁴ Note that the assumption that trust fund surpluses will help future workers fund future benefits has never been unanimously accepted. See Alicia Munnell and Lynn Blais, "Do We Want Large Social Security Surpluses?" *New England Economic Review* (September/October 1984): 5-21, and Robert Meyers, "Social Security and the Federal Budget: Some Mirages, Myths, and Solutions," *Journal of the American Society of CLU and ChFC* (March 1989): 58-63.

⁵ For example, the revised test to determine the trust funds' long-term financial condition became stricter in 1992, and the methodology used to

generate the economic assumptions was also changed. See Michael Anzick, "1991 Social Security and Medicare Annual Reports Revise Insolvency Projections," *Employee Benefit Notes* (August 1991): 1-8. The change in assumption generation means that "assumptions for the future have been revised in a less optimistic direction." See Eugene Steuerle and Jon Bakija, *Retooling Social Security for the 21st Century* (Washington, DC: Urban Institute Press, 1994).

⁶ In particular, program solvency is most sensitive to mortality and nativity assumptions, an area of controversial debate even within the federal government. For example, the Census Bureau's mid-range projections predict 3.6 million more persons aged 85 and over by 2050 than the OASDI Trustees' mid-range assumptions. Some academics project that numbers will be even higher. See "U.S. Population Projections: 2050 Ages 85 and Older," *National Institute on Aging and Census Bureau estimates*, 1996.

Whatever one's perspective on the trust fund reserves' efficacy in prefunding OASDI benefit obligations, projections show that the current FICA tax rate alone will be able to cover about 76 percent of projected program liabilities by 2029.

obligations is not going to help rein in overall tax rates tomorrow. Others argue that overall tax rates would be the same or even steeper in the future if the government had borrowed money from higher-interest lending sources in the private sector or had raised current income taxes instead of borrowing OASDI trust fund reserves. Conversely, some speculate that the federal government would not have expended as many resources had the Social Security trust funds not been available.

Whatever one's perspective on the trust fund reserves' efficacy in prefunding OASDI benefit obligations, projections show that the current FICA tax rate alone will be able to cover about 76 percent of projected program liabilities by 2029 (Social Security Administration, 1996). Therefore, without raising additional Social Security revenues, beneficiaries in 2029 may receive only about three-fourths of what they are currently promised. The projected deficit over the 75-year actuarial period from 1996 to 2070 is expected to be 2.17 percent of taxable payroll under intermediate assumptions;⁷ that is, if payroll taxes were increased by this amount in 1996, a 17.5 percent increase, the combined OASDI program would be solvent until 2070. Were the Congress to wait until 2022 to increase taxes without cutting benefits, taxes would have to rise 4.33 percent to 16.7 percent of taxable payroll, about a 35 percent increase, in order to keep the program solvent until 2070.⁸

As a result of this projected shortfall by 2029 of roughly one-quarter of benefits promised, numerous and diverse reform proposals have been

promulgated. Depending on their supporters' beliefs about the merit and viability of the current system, these reforms range from fixing the Social Security system in more traditional ways to transforming the existing system

into a fundamentally different one (Advisory Council on Social Security, 1997). The November 1996 issue of *EBRI Notes* summarizes the main parameters of seven such reform packages (Olsen, 1996).

This *Issue Brief* provides a framework for evaluating and comparing Social Security policies by delineating 11 broad areas of consideration and highlighting some of the relevant questions within these areas. This framework is not a comprehensive list of all considerations but is intended to provide a feel for their complexity and to highlight some of their most popularly recognized interactive possibilities. As the first *Issue Brief* to be delivered in the course of EBRI's Social Security Reform Analysis Project, this report sets the theoretical framework in which to place the forthcoming technical results from the EBRI/SSASIM2 Policy Simulation Model. This model will produce stochastically generated data regarding specific reforms; these data will comprise the content of the next *EBRI Issue Brief* on Social Security.

Policy Evaluation

Sorting through the multitude of information about Social Security proposals in

order to fairly and comprehensively compare and evaluate them can be daunting. Those who do not abandon the effort altogether are often tempted to make it more manageable by focusing on only one or two aspects of policy analysis, often spiraling into enormous detail. Not

⁷ See Board of Trustees, 1996. It is interesting to note, however, that the 1996 Social Security Advisory Council assumes an adjustment of the consumer price index of 0.21 percent, which decreases the expected shortfall from 2.17 percent of taxable payroll to 1.86 percent. See Advisory Council on Social Security, Report of the 1994–1995 Advisory Council on Social Security, Vol. I (Washington, DC: 1997).

⁸ *Ibid.*

only does this “blindness” approach risk losing the forest for the trees, but those who focus on only a few policy considerations inevitably fail to appreciate the interrelated nature of social programs, economics, and other aspects of society. **A change in one aspect of a policy may not only resound throughout all its operations but may also resonate into other policy areas, affecting ostensibly unrelated aspects of the nation.**

If nothing else, the complex evaluation framework delineated in this *Issue Brief* is testimony to the potential shortcomings of any proposals, regardless of their supporters’ intentions or political alignment, that offer professedly simple and sacrifice-free answers to Social Security’s finance issues. In addition, the framework lends itself to varying depths of analysis and comparison by presenting both broad areas of consideration and by enumerating specific questions within these areas. It should therefore be a useful guide to both informed citizens and policy analysts.

There are three broad areas to consider in comparing Social Security policies. The first is identification of the policies’ underlying philosophies and assumptions that affect policy goals. Second, the nuts-and-bolts structure of each policy must be ascertained. Knowing the specific parameters of a plan provides a starting point for predicting programmatic outcomes (i.e., the possible or likely effects of the program for *all* those affected), the third broad area of consideration.

Underlying Beliefs

Differing ideas about the appropriate goals of Social Security policy emerge from varying

underlying assumptions about political, economic, and other human behaviors. In addition, **policy advocates**

differ in their assumptions about demographics and their views on desirable public policy goals, including beliefs about the appropriate delegation of responsibility between government and workers in providing retirement income security. The former difference is perhaps most pronounced in the current debate, and is reflected in the fact that reform packages range in fundamental design from those that would alter Social Security while maintaining the current defined benefit system (i.e., a social insurance system that pools risk) to those that would supplement or replace the current system with defined contribution (i.e., individual) accounts that return each dollar directly to the “family” that contributed the dollar.

Dissent about the appropriate responsibilities of government and workers in providing retirement income can often be traced to differing basic beliefs about human nature and government. This is an especially pronounced difference that arose among members of the 1994–1996 Social Security Advisory Council when it agreed to increase advance-funding for the OASDI program. In part because of differing beliefs about who should maintain and manage advance-funding reserves—individuals or government—the Advisory Council ended up factionalized and proposed three different plans.

Related questions that bear relevance to the design of Social Security policy include: are people forward-looking and able to defer gratification in order to plan for their own retirement; how much paternalism do people require in order to act in their own best interests; how willing and able are most Americans to inform themselves about and adjust to a new type of Social Security system? The answers to these questions affect one’s policy goals because they are directly related to beliefs about how private individuals will respond to public policy change. Similarly, opinions about government workers and political leaders influence predictions of how the government will respond to a new policy.

Fundamental assumptions about the availability and efficient control of economic

resources is also at the heart of much of the current Social Security debate. How much can America afford to spend on Social Security while still tending to other “important” areas? In short, how much money is there to “go around?” How does government intervention in redistributing resources affect economic growth? What is the inherent capacity of the private market to resolve or prevent social problems? Who is better at efficiently managing money, providing retirement security, mitigating risks, etc., the government or the private sector?

Approaching reform from different underlying philosophies means that advocates are at risk of debating on entirely different planes. While it is impractical in time-constrained debate to focus heavily on identifying and evaluating advocates’ underlying beliefs and attitudes, comprehensive policy analysis and comparison mandate recognition of the impact they have on plan goals, on policy discourse, and ultimately, on retirement income policy and outcomes.

Program Parameters

The most fundamental structure in any retirement income policy is basic plan

design. After this is established, many aspects of how the program raises revenue and provides benefits follow. In short, the broad parameters of a policy are plan design and program finance.

Basic Plan Design

Retirement income plans are designed as defined benefit, defined contribution, or a combination of both. In a defined benefit plan, such as the current Social Security system, the goal is to guarantee that, if workers participate, they receive benefits in an amount dictated by a predetermined formula. The government theoretically

assumes complete responsibility for fulfilling Social Security’s promises by mandating contributions and by guaranteeing benefit levels. To guarantee benefits, contributions may have to increase over time.

In a defined contribution system, the plan sponsor’s goal is to specify a method for determining the cost of an individual account while providing more participant choice. A consequence of greater choice is that the sponsor (in the case of OASDI, the government) is absolved from responsibility for guaranteeing benefit levels at retirement. Although the government or employer may set the range of investment options available, participating workers shoulder responsibility for investment gains and losses and therefore assume ultimate responsibility for at least one part of their retirement security.⁹ Possible risks involved with being ultimately responsible for one’s own retirement income are discussed in the section titled Adequacy (see p. 10).

Nevertheless, the government would still play a large part in promoting retirement security under a defined contribution-style Social Security system. At minimum, the government would likely be responsible for providing or ensuring the availability of a vehicle for contribution collection and investment as well as a means of benefit distribution through a system of individual accounts. In most Social Security reform proposals using defined contribution accounts, the government is also responsible for enforcing participation and, perhaps, for providing savings assistance to lower-income workers.¹⁰

Program Finance

The finance parameter defines how a program maintains

⁹ *If one of the investment options were a guaranteed investment contract (GIC), or a similar guaranteed investment like indexed Treasury bonds, technically the issuer would ultimately shoulder some of the investment risk, not the individual investor.*

¹⁰ *The National Thrift Plan proposed by the National Taxpayers’ Union Foundation is an example of a defined contribution-style reform that would require the government to assist low-income workers in making contributions to their personal accounts.*

financial solvency. **Traditionally, government reaction to projected shortfalls in a federal program has taken three forms: raising taxes (“contributions”), lowering expenditures (“benefits”), or issuing debt. In addition to these traditional methods, private market investment is now a popular proposal for dealing with OASDI shortfalls.** This approach attempts to raise program revenue by taking advantage of stock market return rates through investment of Social Security program revenues and/or reserves in equities. It is assumed that stock returns will continue to be higher than bond returns.

Furthermore, **some advocates of using defined contribution accounts in the Social Security system suggest offering or mandating defined contribution savings in addition to the current FICA tax payments. This is another nontraditional approach to maintaining program solvency in light of projected shortfalls.** While similar to a payroll tax in that mandated savings would reduce workers’ current disposable income, optional or mandated savings would not transfer money from worker to government. Instead, optional or mandated savings rates would be deferrals of a share of current wages into personal property vehicles for retirement savings. However defined contribution account assets were invested (so long as widespread default did not occur), this approach would add revenue to the Social Security program by bringing a greater share of payroll into the system.

Whether financial solvency is maintained by levying taxes, curtailing expenditures, issuing debt, investing program funds in the private market, and/or mandating savings, it is necessary to specify the precise means of generating or saving program revenue in order to identify all possible implications. For example, if levying taxes or mandating savings is a means of generating program revenues, then the relevant questions are:

- Who pays these taxes or contributes to the individual savings accounts (e.g., the employer, employee, or others)?

- What would the rates be?
- What is the source of the money (e.g., expenditures on consumption goods, deductions from payroll earnings, taxes on retirement income earnings, etc.)?
- What groups would bear larger tax or additional savings contribution burdens, and which groups would be most affected by secondary effects from these changes?

If Social Security program expenditures are to be reduced, questions arise as to which expenditures and which groups would be affected. In the current debate, some expenditure cuts have been aimed at current and future retirees’ benefits by adjusting the retirement benefit calculation.¹¹ Changes in normal (NRA) and early (ERA) retirement ages, in the retirement earnings test, in the number of working years taken into account in the Social Security benefit formula, in the consumer price index (which is the basis for cost-of-living (COLA) adjustments),¹² in spousal benefits,¹³ and efforts to de-link Social Security benefit levels from the rise in real wages have all been proposed.

¹¹ For example, the *Maintenance of Benefits and Individual Accounts Reform Plans* offered by the 1996 Social Security Advisory Council advocate using workers’ best 38 years of earnings, instead of the currently used best 35 to determine benefits. Averaging in these additional three years will, on average, reduce lifetime benefits by 3 percent. See Kelly Olsen, “Keeping Track of Social Security Reform Proposals: A Summary,” EBRI Notes (November 1996): 1–8.

¹² All three Advisory Council proposals assume that the Bureau of Labor Statistics (BLS) will adjust the consumer price index (CPI), which is the basis on which Social Security benefits are indexed annually. In addition, the National Taxpayers Union Foundation’s National Thrift Plan and Kerrey-Simpson’s Strengthening Social Security Act of 1995 presume a CPI adjustment of -0.5 percentage points (*Ibid.*). The Boskin Commission’s Report to the Senate Finance Committee states that, “while the CPI is the best measure currently available, it is not a true cost-of-living index (this has been recognized by the Bureau of Labor Statistics for many years). Despite many important BLS updates and improvements in the CPI, changes in the CPI will overstate changes in the true cost of living for the next few years. The Commission’s best estimate of the size of the upward bias looking forward is 1.1 percentage points per year. The range of plausible values is 0.8 to 1.6 percentage points per year.” See Michael J. Boskin et al., *Toward a More Accurate Measure of the Cost of Living: Final Report to the Senate Finance Committee from the Advisory Commission to Study The Consumer Price Index* (December 4, 1996).

¹³ *Ibid.*

If any portion of program funding is to come from the issuance of federal debt, the lenders must be identified in order to assess the implications for the rest of the economy. For example, sale of debt to overseas purchasers has different economic implications than domestically purchased debt. In addition, the persons who would bear the burden of paying back additional debt need to be identified, along with the extent of their burden as determined by interest rates, amortization period, and competing demands on their resources.

If private market investment is included in the reform, the next question is, who makes investment choices and who bears investment risks? If the government is to invest and assume any inherent risks, rules about investment procedure and composition must be established to guide the new reform and safeguard against possible abuses. Specifically, the following considerations would arise should the federal government become a major stockholder in the private U.S. market:

- In what percentage of the private market will the government become a stakeholder?
- If the government owns stock with voting shares, will it vote and, if so, how?
- Will the federal government voting its share give the government “inappropriate” and/or “undesirable” control over the operation of the private market?
- If the government declines to vote its shares, then is it “problematic” that the remaining voting shareholders will have disproportionate influence?
- How will guidelines be established for government investment performance reporting timetables, and what will these guidelines be?
- How will the government choose investment funds,

and will “social investing” occur, whereby the government chooses investment funds based on its charge to promote public well-being (e.g., not investing in a company known for Environmental Protection Act violations or in a company that produces a product the Surgeon General’s Office deems as detrimental to health)?

- Will investment be based on economically targeted investments (ETIs)? (Explained more fully on p. 20).
- Will the government simply try to index¹⁴ the stock market?
- How will market gains and losses be actuarially accounted for over time? Will the conservative rules applied to private pensions by the Internal Revenue Service and the Pension Benefit Guaranty Corporation be followed?¹⁵

If a reform is adopted that allows individuals to make their own investments in the private market, then, again, rules about investment procedure and composition must be established to guide the new program and to safeguard against possible abuses. In addition, if investments are held by individuals, issues of property ownership and control arise, such as:

- Are contributions mandatory or optional?
- Where can the individual keep his or her individual account (e.g., can accounts be held in the individual worker’s bank or brokerage firm of choice or will they be maintained by the government)?
- Are individual accounts inheritable wealth?
- Can workers access their individual account funds for purposes other than retirement?
- Should the federal government be able to control investment options?

¹⁴ Index funds seek to mirror the performance of the stock market by investing in every stock in an index. Broadly based index funds are used to ensure adequate diversification. One of the most common is the S&P 500, which tracks the stock performance of 500 of the largest domestic corporations. However, an index could be more inclusive and include smaller companies (e.g., the Russell 3000 index). Other questions would necessarily arise during the implementation of this strategy. For example, should Social Security invest in nondomestic equities or investments other than equity securities?

¹⁵ If the government were to invest directly in equities, the combined OASDI trust fund’s appearance of being funded over the short-term would vary because of variable returns from the private market. Currently, Special-Issue Treasury bonds provide fixed returns. However, the movement of Social Security defined benefit assets into investments with more volatile returns could subject the Social Security trust funds to the same type of conservative rules that apply in determining the funding status of private defined benefit plans.

- Similarly, will workers be required to hold investments using a “life-cycle approach” whereby downside market risk is reduced as retirement age approaches by decreasing equity investment as age increases?
- Will workers be required to purchase or create life annuities at the time they retire, or will they be allowed to withdraw large lump-sum distributions?
- If annuitization is optional, what is the government’s obligation to persons who exhaust their retirement funds prior to death?

Finally, a structure based on individual accounts may create new roles for the federal government. A defined contribution-style Social Security reform plan must specify the government’s role in levying any new taxes, mediating investment risks, helping low-income workers make contributions, issuing or facilitating retirement annuities, and in meeting any other perceived needs arising from the new system’s defined contribution component.

Comparing Outcomes

Attempting to forecast and compare outcomes of programs that have not been implemented

is the most difficult step in making fair and comprehensive comparisons, as **determining program outcome involves a myriad of sometimes very controversial assumptions. In addition, sometimes even ostensibly very small variations in expectations (e.g., one-quarter percentage point differences in annual growth, mortality, retirement, or interest rate assumptions) can, compounded over many years, result in vastly different policy outcome predictions.**

Moreover, outcome anticipation is difficult because the basic assumptions and fundamental beliefs that go into the creation of different pro-

gram goals reemerge as points of difference. For example, if one believes the economy works better the freer it is of government intervention, this belief might cloud one’s prediction concerning a reform that adds to government regulation. Similarly, if one views the economy as working best only with increased government intervention, one might have negative predictions concerning a reform that reduces the government’s role.

Although people’s beliefs and assumptions differ, and therefore so will their policy outcome predictions, it is critical that they at least ask the same comprehensive analysis and comparison questions. Asking the same questions establishes a basic starting point for debate. In addition, if only a few considerations are used, both information required for identifying alternatives to current policy and the comparison will be incomplete.

For the purposes of Social Security debate, there are 11 broad policy outcome considerations: (1) adequacy, (2) equity, (3) monetary costs, (4) other economic effects, (5) effects on the rest of the U.S. retirement system, (6) governmental effects, (7) administrative effects, (8) political effects, (9) social effects (or, nonmonetary cost considerations), (10) protection against uncertainties, and, finally, (11) the determination of the best policy by weighing each of the aforementioned considerations. These outcomes must be identified in terms of three key aspects:

- each outcome’s effect on all demographic groups possibly affected,
- potential short-term and long-term interactions among outcomes, and
- the rationale behind each outcome prediction.

The four points of consideration for outcome prediction rationale are: assumptions used, validity of assumptions, sensitivity of outcomes to assumptions, and robustness of these assumptions over time (i.e., the likelihood that the predicted outcome will persist.) Clearly, sound outcome comparison and analy-

sis defies cursory examination and is a multifaceted process, as further detailed below.

Adequacy

Adequacy measures the degree to which policy objectives are met in terms of benefit provision.¹⁶ In this context, adequacy determination is value neutral. In examining a Social Security system, **vertical adequacy considers whether beneficiaries would receive the benefit levels indicated by plan goals.** (Would actual benefit levels be as “high” as the policy’s goals?) **Horizontal adequacy asks whether all persons targeted to receive benefits would actually receive them.** (Would program coverage be as “wide” as the goals suggest?) For example, would some not receive benefits because they do not know they are eligible or because of administrative errors? Finally, **subjective adequacy considerations ask whether enough beneficiaries would receive enough benefits** (i.e., are policy X’s outcomes good public policy in terms of adequacy?).

A significant amount of discussion about adequacy has surrounded the current OASDI finance debate, as adequacy, in terms of a near poverty-level income base or floor of protection, is one of the Social Security program’s two primary goals.¹⁷ Because Social Security proposals using defined contribution accounts have been popular, potential risks involved in allowing individuals to assume more responsibility for their retirement income security have raised concerns. Namely, the two primary risks are: (1) an individual’s likelihood of using a risk-averse investment strategy, causing his or her returns to be too low to yield an adequate retirement income base or floor and (2) the

individual’s risk of selecting equities or corporate bonds that provide a lower than expected investment return experience.

To determine the likelihood that people will choose risk-averse investment strategies, expected investing behaviors on the part of individual workers have become a paramount adequacy concern. Questions about how to predict investment behaviors under a Social Security system that involves defined contribution accounts include:

- Which historic patterns of investment should be considered (e.g., is the recent past more illuminating about the future than the distant past? Should we look at investment behavior in all retirement plans, including those with both defined benefit and defined contribution components or just those with defined contribution-only plans)?¹⁸
- Would these patterns be likely to continue if a Social Security System with defined contribution accounts were adopted (e.g., would people invest more conservatively if they no longer had a Social Security defined benefit as a “safety net”? Conversely, would people become better at investment by necessity or because of the educational component of the new system?)
- Would the new system require a life-cycle investment approach (see below) to mitigate the possibility of “age inappropriate” investment choices?

Investment predictions tie into adequacy outcomes by asking:

- Are these predicted investment patterns likely to result in the level of retirement security intended by plan advocates (vertical adequacy)?
- If not, how could investment behaviors be altered?

¹⁶ *Ibid.*

¹⁷ The other primary goal of the OASDI program is equity. See Robert Meyers, *Social Security*, Fourth edition (Philadelphia, PA: Pension Research Council and the University of Pennsylvania Press, 1993). Adequacy can have many definitions. Many analysts define adequacy as replacement of the preretirement lifestyle during retirement. Social Security seeks to provide this level of adequacy for very low-income retirees through a richer benefit formula

than that which applies to others. At maximum wage base levels, adequacy is a life-sustaining benefit that is a small percentage of preretirement income.

¹⁸ Some hypothesize that individual defined contribution account investment behavior on the part of workers with defined contribution and defined benefit plans is more aggressive than that of workers who expect to rely solely on defined contribution plans for their employer-based retirement income. The rationale is that the more dependent an individual is on a retirement plan, the less risk that individual is likely to take with the assets of that plan.

- If investment behaviors are to be altered through an educational effort, will there be enough resources to educate all groups and thereby ensure horizontal adequacy?

Concerns related to the risk of losing money in the equities market have led many advocates of defined contribution-style reforms to recommend that equity investment be restricted to broadly diversified funds comprised of stocks with historically strong performance records. If choices are thus limited, the possibility of adverse investment experiences becomes less of a concern than it would be if individuals were allowed to hold undiversified or highly speculative portfolios.

Some fear the risk of vertical inadequacy if retirees were forced to withdraw from their defined contribution accounts for living expenses or convert these defined contribution assets into annuities during a period of economic downturn. Most financial planners suggest that, with age, individuals should gradually convert investments in equities into investments with less volatile rates of return. This “life-cycle approach,” which averts a crisis whereby retirement funds must be pulled out of a down market, could be adopted by Social Security investors voluntarily or through a government mandate. Therefore, this particular risk of vertical inadequacy depends on use of life-cycle investment strategy, not only on the performance of the market at any point in time. However, because some individuals may choose a life-cycle investment approach and others may not if it were optional, questions of horizontal equity emerge (discussed in the next section).

Recall that adequacy, like every outcome consideration, must be identified in terms of what demographic

groups are most affected by programmatic adequacy lapses. In addition, it is important to understand how adequacy predictions were generated as well as what effect the adequacy level prediction may have on other considerations (e.g., political or social considerations or the burdens placed on other government programs).

Equity

Equity is the current OASDI program’s second primary goal (Meyers, 1993). Equity considerations involve identifying policy outcome “winners” (those who will or do receive disproportionate benefits) and “losers” (those who will or do bear disproportionate costs). Lifetime equity is often measured by ascertaining replacement rates, internal rates of return, and money’s worth ratios.¹⁹ Subjective equity considerations first include determination of whether programmatic distinctions made between beneficiaries’ level of benefits (e.g., eligibility requirements and redistributive components) are fair. The following questions emerge:

- Does the program reward certain behaviors, e.g., continuous work force participation, increased savings behavior, etc., with greater benefits, and are these criteria fair?
- Is the program redistributive and should it be? If so, how much?
- How much should spousal benefits provide?
- Are like beneficiaries treated alike, e.g., are there “notches?”²⁰ Are persons likely to receive different benefits solely as a result of investment “luck,” and is this an acceptable outcome provided that each beneficiary has equal investment opportunities?

¹⁹ Replacement rates are the ratio of benefits payable at age 65 or the onset of disability to pretax earnings in the prior year. Some analysts also define them as replacement of average lifetime earnings. Internal rates of return are the rates of return at which the present discounted value of future benefits is equal to the present discounted value of taxes paid. Money’s worth is the ratio measuring the present value of the benefits a typical individual has received or is expected to receive compared with the present value of the payroll taxes and other contributions that he or she has paid or is expected to pay, discounted at

the actual past and projected future rates of return on government bonds held by the Social Security trust funds. Advisory Council On Social Security, “Comparison of Plans,” Report of the 1994–96 Advisory Council on Social Security, Vol. I (Washington, DC, 1996).

²⁰ “Notches” refer to situations when younger workers with the same earnings records get lower real benefits than older workers. For an explanation of the notch issue, see Eric Kingson and Edward Berkowitz, *Social Security: A Policy Primer* (London, Auburn House: 1993).

A second equity consideration includes identification of the distinctions made between contributors' levels of burden. Are there disproportionate cost burdens imposed upon one group or age cohort? If so, are these distinctions fair?

Another equity question takes into account both costs and benefits: are rates of return fair across groups and/or age cohorts? In addition, is it more important to consider whether participants have equal opportunity for receiving fair rates of return or to consider only the level of benefits actually received? Finally, equity, like every outcome consideration, must be identified in terms of which demographic groups are most affected by programmatic equity lapses. In addition, it is important to understand how equity predictions were generated and to consider what effect this prediction could have on other outcomes.

Program-Specific Monetary Cost Considerations

Comparing reforms involves projecting short-term and long-term program costs as a percentage of Gross Domestic Product (GDP), taxable payroll, and real dollar values in the following areas:

- one-time start-up costs,
- transition costs,
- operating costs,
- administrative costs, and
- borrowing costs.

Assuming cost predictions are valid, these costs must not only be averaged to ascertain actuarial balance over a given period of time; their distribution over time must also be identified. For example, does the actuarial balance dip below zero at any time? If so, what are borrowing and tax rates predicted to be at that time? Is the average cost low but the distribution unstable in that sometimes costs are very low while at other times they are extraordinarily high? Finally, cost outcomes must be identified in terms of the demographic profiles of the

people most likely to be affected in the immediate future and over time.

Cost estimates themselves are only credible if the assumptions and calculations used to derive them are valid. For this reason, it is crucial for fair comparisons to ascertain assumptions and data used, examine their validity, and assess the robustness of the results to changes in the assumption variables over time. It is also crucial to apply a sensitivity analysis²¹ to determine cost estimates' sensitivity to changes in assumptions. One policy may have low costs only if certain variables remain constant and high costs if one variable changes. Another policy might not have the potential of reaching the low costs that the first policy is capable of reaching but may instead provide a more steady and predictable cost estimate because of its ability to maintain its cost rate within a range of economic scenarios.

Finally, cost outcome predictions must be viewed in relation to other outcome predictions in both the short and long term. For example, proponents argue that a higher cost Social Security policy that mandates individual private investment would only necessitate reduced consumption until the standard of living gains generated from increased availability of investment capital are realized, at which point consumption would rise higher than its current rate. On the other hand, some argue that the cost of a Social Security program with defined contribution accounts would initially decrease because of higher market returns, but that costs would eventually increase while equity returns fall as the market adjusts to the new allocation of resources. (Such possible macroeconomic interactive effects will be explored more thoroughly in the next section.)

²¹ For example, there is a fair amount of disagreement with respect to the "best" assumption to use for improvement in future life expectancy. Sensitivity analysis on this variable would consist of running cost estimates under some baseline set of assumptions (perhaps those used in the Trustee's report) and then rerunning them assuming life expectancy actually increases faster (slower) than the baseline. The new cost estimates will be higher (lower) for each reform proposal, but the important point is whether the relative and absolute rankings of the alternatives vary as the life expectancy assumption is modified.

An integral part of evaluating any retirement policy is the identification and examination of its intended and unintended effects on labor force behavior.

Extra-Programmatic Economic Considerations

Labor Force Participation—Pension systems, whether public and private, can encourage or discourage certain behaviors. In particular, the amount of benefit, the benefit accumulation rate prior to retirement age, the age at which benefits become available, and how future benefits change with continued labor force participation after retirement age affect workers' labor-leisure choices and savings-consumption choices. Therefore, an integral part of evaluating any retirement policy is the identification and examination of its intended and unintended effects on labor force behavior.

Many reform plans, as well as the changes in the current Social Security system already legislated, are structured to provide incentives to delay retirement. The accompanying argument is often that, although people today are living longer than they did in the 1930s when the Social Security retirement age was established, the NRA remains at age 65 for full benefits and at age 62 for early retirement.²² While a gradual, two-year increase in the NRA was legislated in 1983, some advocate a more rapid increase to age 67 than that scheduled under current law and/or extending the NRA even further.²³ Nonetheless, many of these proposals' most ardent supporters recognize that raising the age for early and/or full retirement benefits is not without some controversial implications. Evaluation of policies to raise the early and/or full retirement age(s) includes the following considerations:

- Should public policy be concerned with when people retire, or should retirement age be viewed as a

personal matter? If policy ought to attempt to influence retirement age, how do proposals affect the following issues:

- How will a rise in the age at which Social Security retirement benefits become available affect workers with physically demanding occupations who will be less likely to be able to work in their occupations at later ages?
- If many laborers cannot work to the age of benefit eligibility, what is society's obligation to use resources to support these persons (e.g., by paying disability benefits), and to what extent will these costs offset the economic benefits of delayed retirement for the rest of the population?
- How will the private sector respond to increased labor force participation after age 62? Specifically, will private employers be allowed to raise the age of eligibility for private pension plans to correspond with the change in Social Security policy? If allowed, will they?
- Will age discrimination impede increased participation of older workers in the work force?
- Will there be enough jobs for older workers both numerically and in terms of appropriateness for the level of physical activity most persons over age 67 can perform?
- How will an increased number of older workers affect rates of unemployment, job opportunities, and career advancement for younger workers?
- If employers are expected to continue to employ aged workers, can they afford to do so at the pay increase schedules currently common in businesses, or will pay schedules designed to rise with seniority have to be curtailed and to what extent?

Savings—Unlike the current system, many Social

²² In 1935, average life expectancy at age 65 was about 77 for men and 78 for women. It has since increased to 80 for men and 84 for women (Advisory Council on Social Security, 1997).

²³ Two plans put forth by the 1994-1996 Social Security Advisory Council, the Individual Accounts and the Personal Security Account Plans, would increase the NRA more rapidly than current law, resulting in an NRA of 67 for persons turning age 62 in 2011, as opposed to 2022 under current law. These reform plans would index the NRA to longevity thereafter, estimated to be about one

month every two years. In addition, Kerrey-Simpson's Strengthening Social Security Act of 1995 proposes an NRA increase to age 70 by 2029. See Kelly Olsen, "Keeping Track of Social Security Reform Proposals: A Summary," EBRI Notes (November 1996): 1-8.

Security reform plans are designed to increase workers' saving incentives and thereby lift net national saving. Many argue that an increase in net national saving will boost the capital available for investment and therefore spur economic growth.²⁴ Increased voluntary savings incentives or a program of mandatory saving raises several questions:

- To what extent can the government affect net national saving, since an increase in one area of saving could be offset by a decrease in other areas of personal and governmental saving if overall consumption is not also reduced?
- How fast can the economy grow, and what is the ability of a national retirement system to increase growth rates?
- In a nation with many competing needs for resources, what is the appropriate priority level of increasing national saving, i.e., how much can America afford to save?
- How would individual and employer contributions to employment-based defined contribution plans be affected by higher Social Security tax rates and/or mandatory defined contribution saving plans?

Market Interactions—In addition to providing incentives to promote certain worker behaviors, a Social Security system exerts influence over the behavior of both government bond and private investment markets.²⁵ As indicated, many Social Security reforms have been specifically designed to promote saving so as to boost investment capital and thereby spur economic growth. However, some potential market effects may be unintended. Social Security policy's intended and unintended influence on the behavior of private investment and government bond markets is an (often highly

technical) area of increasing interest among economists.

Social Security (OASDI) affects private markets because, with 141 million workers participating as of 1995 (and with several plans proposed to increase that number),²⁶ the program collects and allocates large sums of capital. In 1995, income of the Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI) programs was almost \$400 billion, which included a \$59.7 billion surplus invested in Special-Issue Treasury bonds (Board of Trustees, 1996). By the end of 1996, OASDI program income was expected to have exceeded 5 percent of the nation's GDP, according to intermediate assumptions (Board of Trustees, 1996). Therefore, **increased incentives through the Social Security program to save and/or to invest in private equities could prompt reallocation of significant capital and affect markets for this reason alone. Likewise, any changes in the amount of money handled by the Social Security program, the distribution of that money, or the investment thereof could also affect the behaviors of private and public markets.**

The complexity with which changes in the OASDI program could affect markets is illustrated by consideration of the potential effects of the three Social Security Advisory Council proposals. All three proposals involve the reallocation of Social Security assets from Special-Issue Treasury bonds to private-sector investments in equities in order to take advantage of the higher rates of return currently available from the private equity market (Combs, 1996). Treasury bonds are projected to yield annual rates of return that exceed inflation by 2.3 percent, which appears low relative to equity return projections of about 7 percent over inflation (the same average as that over the past several decades) (Aaron, 1996; Social Security Advisory Board, 1996). Advocates of investing Social Security assets in equities expect the average return to continue to outperform rates on Spe-

²⁴ For example, the National Taxpayer Union Foundation's Thrift Savings Plan, the Personal Security Plan and reforms advocated by Jose Pinera of the Cato Institute are designed to spur economic growth through increased private-sector investment. See Kelly Olsen, "Keeping Track of Social Security Reform Proposals: A Summary," EBRI Notes (November 1996): 1–8.

²⁵ The private investment market includes corporate bond and corporate equities.

²⁶ For example, all three Advisory Council plans would mandate that new local and state government employees be covered under the Social Security system. See Ann Combs, Social Security: Options for Reform (William M. Mercer, Inc).

No one knows precisely how the markets would respond to a shift of Social Security assets from Treasury bills to equities, as the economic effects of reallocating Social Security assets is a challenging area that scholars have just begun to address.

cial-Issue Treasury bonds.

An initial concern about investing Social Security funds in the private market is the ability of the private sector to absorb such large additional resources. Hence, one consideration for a Social Security system that would reallocate funding into private markets from other parts of the government or society is how quickly this transition would occur. Other concerns involve the expectation and likelihood of equity returns remaining as high (or nearly as high) as they have averaged over the past several decades.

Depending on the reform plan, switching Social Security assets from Treasury bond investments to equities could mean less demand for Treasury bonds initially because the Social Security Administration, a major purchaser, would no longer be buying as many of them, if any (e.g., assuming a balanced budget by 2002). To attract investors, the Treasury might need to increase its interest rates on government bonds.

If interest rates increase, some economic forecasters theorize that at least two forces could lower returns on equities. First, higher demand for equities might mean that equity prices could be bid up, causing their long-range rates of return to fall. In addition, higher interest rates might hinder business investment activities, which would be likely to cause the market value of equities to fall because of expectations of lower rates of return. Some argue that this effect could be mediated if international markets are large enough. In fact, no one knows precisely how the markets would respond to a shift of Social Security assets from Treasury bills to equities, because the economic effects of reallocating Social Security assets is a challenging area that scholars have just begun to address. However, given a reallocation of Social Security assets, the assumption that equity returns would remain at their current levels is not one to be taken without careful thought about market interactions.

Related considerations concerning the intercon-

nected nature of markets include the following:

- If a new Social Security policy requires the government to repay part or all of the money it borrowed from the Social Security trust fund sooner than under current law, would taxes have to be raised sooner and more steeply?
- Similarly, if the federal government is prohibited from borrowing any additional revenue from the OASI and DI trust funds, can it be expected to reduce its annual budget deficit in response by raising taxes or reducing spending?
- If the government does not reduce its annual spending, will it borrow money from the private sector to replace the money it would otherwise borrow from the Social Security program?
- If the government borrows more money from the private sector, will interest rates rise on the money that the government borrows in the future?
- If interest rates on government borrowings rise, will the interest on the federal debt rise and prompt an increase in income taxes?
- If income taxes rise as a result of a new Social Security policy that reallocates revenue into the private market, how much will the increased tax rates offset the benefits of the new policy?

Retirement Annuity Provisions²⁷—A Social Security reform with a defined contribution component could provide optional or mandatory annuitization. Like concerns that the equity market would be unable to absorb the flow of assets from a defined contribution-style Social Security policy, there are concerns about how quickly and adequately the private annuity market would be able to adjust to increased demand. In addition, there is some debate about the impact on annuity prices of optional annuitization. Some believe that increased

²⁷ For a detailed explanation of different types of annuities, see Graves, 1994.

demand would modify the adverse selection inherent in a voluntary annuity market and thus lower annuity prices, whereas others predict that the price of purchasing an annuity would ultimately remain the same.²⁸

Mandatory annuitization upon retirement raises the following equity considerations:

- In the past, the employee's gender was a factor in determining the annual retirement benefit that could be provided under a defined contribution plan. If a male and a female were the same age and had exactly the same amount accumulated under the plan, the male employee would receive a higher annual pension than the female employee. This was because the female employee was expected to live longer and, in anticipation of this, the same total amount was expected to be paid over a longer period of time. Because of the difference in life expectancies, the actuarial value of the pension, in both cases, was considered to be the same. In 1983, the Supreme Court ruled (in *Arizona Governing Committee v. Norris*) that life annuities under an employment-based defined contribution plan must be provided on a uniform basis.²⁹
- Unlike the current Social Security system, annuities in the private market are not indexed. Because women tend to live longer, inflation has more time to erode their purchasing power in retirement, and therefore lack of indexation disproportionately affects women.
- While guaranteeing a spousal benefit if the beneficiary is married, the current Social Security system provides equal benefits to workers with the same

covered earnings history regardless of marital status. The only way for a nonworking spouse to receive a benefit under a private market annuity is if a joint spousal annuity is purchased. Unlike the Social Security system, receiving a joint spousal annuity from the private market means that, in exchange for joint spousal benefits, the working spouse accepts a lower monthly annuity payment.

- Would joint spousal annuities be mandatory for individuals who qualify for Social Security benefits but whose spouses do not? If not, would this mean that nonworking spouses' retirement security would be left to the benevolence of their partners?
- If some nonworking spouses were not included in their partners' annuity contract, how much would society have to spend in terms of government programs to alleviate these spouses' potential poverty in old age? How much would this expense offset the advantages of the program?
- Could annuities issued by the Social Security Administration avert the above equity concerns? If so, how?

The foregoing questions highlight a difference in the fundamental objectives of the current Social Security system and the current private annuity market system.

In terms of providing guaranteed payments for life, the private annuity market emphasizes individual equity considerations that seek to equate individual contributions to expected individual benefits on an actuarial basis, leaving individuals with the responsibility of ensuring the adequacy of their own and their spouses' retirement income. In contrast, the Social Security system combines the goals of individual equity and social adequacy so that benefits are based on need as well as contributions (albeit indirectly) (Meyers, 1993). For example, if individual A paid twice the contributions as individual B and all other factors were the same (e.g., age and gender), A would expect to receive approximately twice the monthly benefits in a private annuity market system. Under the current Social Security system, A would expect to receive more than B

²⁸ Much of the debate focuses on load factors, particularly the portions represented by the cost of adverse selection. For an excellent historical study of the cost of adverse selection in the private annuity market, see Mark Warshawsky, "Private Annuity Markets in the United States: 1919–1984," *Journal of Risk and Insurance* (September 1988): 518–528.

²⁹ It should be noted that employees can buy annuities from insurance companies on the open market (i.e., apart from the qualified plan). At this time, insurers are not required to offer such annuities on a unisex basis, although legislation that would require this has been proposed. Even though not required to do so, however, many insurers provide for unisex premiums.

The result of the Social Security debate could potentially have great impact on the design of the employment-based pension system.

(all things being equal); however, the benefit would be less than twice the amount B receives.

If annuities were not mandated and lump-sum distributions or any type of periodic payments from Social Security private accounts were permitted, **individuals might desire to self-annuitize their savings in order to ensure a stream of income over the course of their retirement. Self-annuitization is a strategy that an individual can use to ensure that he or she does not outlive a particular amount of principal.** This is accomplished by dividing the account balance each year by his or her life expectancy at that point in time and limiting the annual consumption to the amount determined by the calculation. This step is repeated each year, and the annual amount will vary from year to year as a result of investment income and changing life expectancies. The requirements involved in successful self-annuitization raise concerns about: (1) the willingness and ability of retirees to perform these annual calculations and to practice fiscal restraint, and (2) the fact that a certain percentage drop in the markets would yield a proportionate drop in annual consumption. As a result, the appropriate role of government or business paternalism is raised.

Effects on the Rest of the U.S. Retirement System

The result of the Social Security debate could potentially have great impact on the design of the employment-based pension system. As mentioned earlier, an increase in the NRA and/or early retirement age would probably result in adjustments in employers' willingness to retain older employees and the designation of retirement ages for employment-based pension plans. (See the discussion under Labor Force Participation and Savings on pages 12–14.)

In 1993, nearly 48 percent of employees in medium and large private establishments were covered by defined benefit pension plans using benefit formulas that were integrated with Social

Security provisions (U.S. Department of Labor, 1995).³⁰ **Hence, if Social Security benefit provisions change, the employers of approximately 7.7 million workers will most likely have to readjust their retirement plan formulas.**³¹ The total number of employers who would have to readjust is even higher, as the above figure does not include employees of small private firms who may also be participating in integrated pension plans. **Readjusting benefit formulas for Social Security changes would entail an administrative burden in addition to any other potential burdens imposed on private pension sponsors under a new Social Security policy.**

Some other considerations with respect to potential changes in Social Security policy on employment-based pension sponsors are the following:

- Would tax incentives for employment-based pensions—public and private—be reduced if Social Security costs put pressure on other parts of the federal budget?

³⁰ *Integration with Social Security can be done in several ways, but the basic purpose of integration is to allow employers to take credit for the fact that they are financing one-half of the payroll tax assessed for the Social Security retirement benefits for their employees. In certain defined contribution plans, employers are allowed to contribute a fixed percentage of compensation for all parts up to a specified level of compensation and then a larger percentage for compensation in excess of that amount (up to the 401(a)(17) limit). The permitted disparity between the two percentages is controlled by Internal Revenue Code sec. 401(l).*

Integrating a defined benefit plan with Social Security is a more complicated procedure; however, the employer is allowed to indirectly increase the generosity of the benefit provisions for employees earning in excess of the maximum taxable wage base (\$62,700 in 1996) in recognition of the fact that no Social Security retirement payroll tax has been paid by the employer on these wages.

For a complete explanation of integration provisions, see Chapter 8 (for defined contribution plans) and Chapter 14 (for defined benefit plans) of Everett T. et al., Pension Planning, Seventh edition (Homewood, IL: Irwin, 1992). Also see Employee Benefit Research Institute, Fundamentals of Employee Benefits, Fifth edition (Washington, DC: Employee Benefit Research Institute, 1997) and James Schulz and Thomas Leavitt, Pension Integration: Concepts, Issues and Proposals (Washington, DC: Employee Benefit Research Institute, 1983).

³¹ *EBRI tabulation from the U.S. Department of Labor, Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1993 (Washington, DC: U.S. Government Printing Office, 1995).*

- Would employees demand that employment-based pension plans be more generous under possible benefit cuts resulting from Social Security reform?
- Since employees who retire early sometimes receive bridge benefits from their employment-based pension plans until they become eligible for Social Security, would an increase in the NRA raise bridge costs and reduce bridge benefits as a result?
- How much in resources can employment-based pension sponsors be expected to allocate in adjusting to new Social Security policy in a time when they, too, will need to prepare and provide for demographic pressures on their own plans?
- If part or all of Social Security's current defined benefit system were reformed to include defined contribution accounts, would workers feel uneasy about not having as much of a defined benefit guarantee in retirement and therefore pressure employers to expand employment-based defined benefit plans in terms of benefits and sponsorship? Would employers be encouraged to abandon employment-based defined contribution plans?
- If Social Security policy is changed to encourage more delayed retirement, will employer health care costs rise as a result of an older work force? If so, will this reduce the funds available for employment-based pension plans?

Not only is there concern as to the extent employers sponsoring pensions will adjust to changes in Social Security policy, but there is also debate as to how workers participating in employment-based plans will alter their behavior and how these adjustments will affect their retirement security.

- If private investment accounts are incorporated into Social Security, would workers, upon seeing large accumulations in their Social Security accounts, be less likely to invest in employment-based plans?
- If so, will this negatively impact retirement security, or will the accumulations in Social Security accounts

be enough to sustain secure retirement?

- If the new Social Security program has a defined contribution component with educational efforts, will this increase workers' awareness of the necessity and benefits of saving as well as the potential effects of inflation and thereby increase worker participation in employment-based pension plans?
- If the reformed Social Security system provides lower expected benefits than today, will workers realize the need to increase savings in their defined contribution employment-based plans to the extent permitted by the employer?

Ultimately, changes in the Social Security system could impact all legs of the retirement income stool,³² potentially changing its very constitution.

Governmental Effects

The Social Security OASDI program is not the only government program that promotes retirement security. For example, Medicare Part A and Part B assist in covering the costs of acute inpatient care and short-term rehabilitation as well as physicians' visits and outpatient procedures; Medicaid pays for long-term care services for the impoverished elderly; the Supplemental Security Income (SSI) program and food stamps program assist poor elders in meeting basic living expenses; and the office of Housing and Urban Development (HUD) sponsors low-income housing programs for seniors.

Because the OASDI program is but one part (albeit a large one) of the entire U.S. system to prevent poverty in old age, **the effects of the current system or a new Social Security policy on the nature of the nation's entire system of old-age assistance**

³² The retirement income stool has traditionally been defined as having three legs: Social Security, individual savings, and private pension income. EBRI publications, beginning in 1979, have suggested that there are more "pillars," including wages from work, government assistance, survivor benefits, inheritances, long-term care insurance, etc.

policy must be considered.

- What effects will Social Security reform have on the Medicare program, which is facing more immediate insolvency projections and higher predicted cost growth?
- To what extent do potential cuts in Social Security benefits simply force cost shifting onto other programs that target the elderly? If cost shifting occurs, to what extent, if any, does the program stigmatize beneficiaries by either directly means-testing Social Security or by making more elders dependent on other means-tested programs?
- To what extent does the maintenance of current levels of Social Security benefits detract from the amount of money available to other government programs related to the elderly?
- To what extent does the redistributive generosity of the Social Security program discourage work and savings, thereby promoting dependence on government programs in retirement?

Just as the Social Security program is only one part of the federal government's efforts to secure retirement, these programs to benefit the elderly are but one part of the entire U.S. federal government's operations. Considerations related to other government functions include the effect of Social Security costs and benefits on:

- other parts of the OASDI program that do not directly target the aged (For example, will Disability Insurance (DI) be separated from the rest of the system under a new reform? Will old-age and survivors benefits be separated from survivors' benefits for younger spouses and dependents? How will an increase or decrease in the generosity of one OASDI program affect the resources and efficiency of another?);
- total public spending as a percentage of GDP;
- federal deficit burdens;
- resources available for other government programs such as environmental protection, welfare to children, defense, public health, highways, education, and

national security (opportunity costs from allocating resources to the Social Security program that could have gone to other programs);

- amount of federal tax revenues collectible from the private sector; and
- confidence in the federal government and in the Social Security program.

Administrative Considerations

Administrative costs are not the only administrative considerations that must be factored into policy comparison and evaluation. While related to cost, complexity of administration is a consideration in its own right, as increased complexity can lead to decreased program efficiency and thus to decreased political support. **In order to assess administrative complexity, one must determine the point of equilibrium whereby a program is complex enough to meet the needs of a nation of different individuals in various circumstances yet straightforward enough to run efficiently.** It is difficult to discern the appropriate levels of complexity for the combined OASDI program, which covered 141 million workers and 43.4 million beneficiaries in 1995 (Board of Trustees, 1996) and whose coverage is continually growing.

Administrative considerations include estimates of how often the policy will require regulatory changes and of the policy's flexibility adapting to the nation's ever-changing social, economic, and regulatory environments. Similarly, comparison and evaluation require the prediction of how regulation will evolve. An initially simple policy can become a tangle of regulations over time under political pressures. Finally, administrative considerations include identifying the office that wields administrative power, evaluating the office's past performance, and predicting its future behavior.

Political Considerations

Many political considerations involve the political feasibility of passing and regulating a policy. For

example, today's Social Security debate includes various opinions about how willing Congress would be to mandate increased OASDI contributions if such contributions were not "taxes" but "mandatory savings contributions" instead. In addition, reservations about regulatory feasibility are reflected in concerns about administrative burdens and complexity.

Political risk issues seem to have dominated political considerations, however. Political risk is the likelihood that a program or policy will lose its political support or that policymakers will make changes that prevent stated policy objectives from being realized. The political risk inherent in the current system is evident in surveys that have found high support levels for Social Security among younger workers but low levels of confidence that they would receive full benefits from the current system.³³ In addition, younger generations have lower expected rates of return on OASDI contributions. As a result, some reform proponents believe that younger workers may provide less future support for the program.

Another political risk is that policymakers might wait so long to reform the current system that the changes needed for balance would be extreme, rather than limited, and cause political upheaval. A further risk relates to what might happen with a system of defined contribution accounts were individuals to invest in the stock market. If a market drop were to occur (especially if it happened right before a significant number of persons planned to retire), would the public demand restitution or a policy reversal?

A political risk concerning the use of defined contribution OASDI accounts to augment a base defined

benefit program is the possibility of declining political support for the defined benefit part of such a "two-tier" system. Social Security's equity goal most favors middle and high income participants, whereas its adequacy goal most favors workers with lower incomes. Lower income workers tend to have a higher percentage of their preretirement incomes replaced by Social Security, but those with higher incomes tend to receive higher absolute benefits. A two-tiered system would make explicit which benefits originate from the program's equity goal (via the defined contribution account, which would reflect contributions and would thereby most favor middle and high income workers, who have the most to contribute) and which benefits originate from the adequacy goal (via the defined benefit account, which would reflect entitlement and/or need, possibly most favoring lower income workers). Would higher and middle income workers withdraw support from the adequacy (defined benefit) tier and press for the expansion of the equity (defined contribution) tier, preventing a two-tiered program's adequacy goals from realization?

Additional potential risk involved in the private investment of Social Security funds, either by individuals or the government, are issues of economically targeted investments (ETIs) and corporate governance. Under a system of individual accounts, unless workers were 100 percent free to invest however they choose, the government might establish the range of "appropriate" investment options available and any requirements for life-cycle investment. Among the considerations are:

- Would criteria for selection of domestic and international investment options for workers be based on social considerations such as a company or industry's compliance with Environmental Protection Act standards or a nation's human rights practices?
- Would options be based on consistent returns history, such as on the basis of whether a company's stock were "blue-chip," or would ETI options be mandated?
- If investment options were selected on the basis of "blue-chip-type" standards or ETIs, would this unfairly discriminate against other enterprises?

³³ See Employee Benefit Research Institute, Mathew Greenwald and Associates, and the American Savings Education Council, 1996 Retirement Confidence Survey (Washington, DC: Employee Benefit Research Institute, 1996); Employee Benefit Research Institute/The Gallup Organization, Inc., "Public Attitudes on Social Security, 1995," EBRI Report G-62 (Washington, DC: Employee Benefit Research Institute, 1995); and Virginia Reno and Robert Friedland, "Strong Support but Low Confidence: What Explains the Contradiction?" in Eric Kingson and James Schulz eds., *Social Security in the 21st Century* (New York: Oxford University Press, 1997).

The government might exert more influence on investment choices if it directly invested trust funds in the private market itself, unless investment is in index funds. Concerns are also raised about real or imagined scandals between the government and businesses that are vying for selection as a Social Security investment option or as part of the index in which Social Security invests. Such controversy could erode political support for the program and thereby expose defined contribution-style Social Security plans to political risk.

In addition, unless regulation of individual investment brokers is adequate, some fear market “scams” could emerge, which would undermine support for a system using defined contribution accounts. Others suggest that regulation of public pension funds, such as the Federal Thrift Plan for federal government employees, shows that the necessary regulation and enforcement bodies are in place to ensure that such quagmires can be averted. However, this still leaves some concerned about corporate governance issues should the government own large blocks of stock in public corporations.

A final risk relates to defined contribution account balances. Would policymakers decide to allow preretirement access to funds under the pressure of other goals, as they have with individual retirement accounts (IRAs) and 401(k)s? And, if they did, what would be the retirement income implications? Should people be allowed access to their accounts (through loans or early distributions) prior to retirement age for certain circumstances or emergencies such as financing education, starting a business, paying medical bills, or avoiding bankruptcy? If yes, which circumstances would be appropriate for early withdrawal or loans? Would early withdrawal or loans involve a penalty? If Social Security account balance holders were unable to make their mortgage payments because of preretirement withdrawal or loan restrictions, would they demand that the system be changed? The history of access rules for private pensions and IRAs suggests that this issue would be regularly revisited.

Some oppose preretirement access to defined contribution-style Social Security accounts, arguing it would undermine the system’s political stability by eroding its financial stability, since preretirement use of funds would affect the adequacy of postretirement benefits. Others support preretirement access in situations where a person would otherwise need government support on the grounds that, ultimately, preretirement access for these individuals would have no net effect on government expenditures. If such persons could withdraw from their Social Security accounts in their preretirement years, the government may need to support them during their old age; if such persons were denied preretirement access, the government may have to support them until old age. Those not opposed to preretirement access argue that, either way, the government pays and Social Security account accumulations are used.

Social Considerations

Social considerations involve the identification of costs and benefits that do not have a quantifiable, objective monetary value but are nonetheless crucial to factor into the comparison and evaluation of Social Security policy. Social considerations that have been identified include:

- Are people informed about the financial protection and risks involved in the program? (Some, for example, have raised the question of whether defined contribution-style programs could ever adequately inform younger workers of financial risks, since younger workers have lived in an era of relatively constant high returns from equities, where risk existed but was not realized on aggregate.)
- Does the program promote financial literacy among participants?
- Does the program provide a sense of national community and cooperation?
- Does the program contribute to peace of mind in regard to the adequacy of aged family members’

Trade-offs occur in a system that attempts to mitigate uncertainties. The primary trade-off is the lack of individual control that results from participation in a program that pools risk.

incomes and in one's own retirement security?

- Does the program help mediate the burdens of younger family members in caring for and financially supporting their aged?
- Is the program's public discourse honest? (For example, are tax increases and benefit cuts presented straightforwardly to the American public, or are they hidden behind more politically palatable rationales?)
- Are Social Security costs being shifted to other programs without this being understood by the American public? Does the program make excessive promises?

Because of different fundamental beliefs about the appropriate nature of a Social Security system, one may find all, some, or none of the above social considerations appropriate to ask of Social Security policy. What social considerations are considered germane depends significantly on the subjective value framework and fundamental beliefs taken into account in determining appropriate OASDI policy goals.

Protection Against Uncertainties

Related to the foregoing social consideration of peace of mind, a Social Security program's ability to protect against uncertainties, or risk, means that at least one part of individuals' and households' retirement security cannot be eliminated by shocks in earnings or expenditure needs such as disability, unemployment, unforeseen longevity, or unexpected inflationary growth (Boskin et al., 1996). The current system protects against inflation and unexpected longevity by indexing and annuitizing benefits. Furthermore, the current system attempts to protect all aged and/or dependent married persons from the risk of losing support because of a spouse's death by providing survivors' benefits under the retirement program. Finally, the current OASDI system mitigates the effects of shocks to earnings from disability by providing disability insurance.

Trade-offs occur in a system that attempts to

mitigate uncertainties. The primary trade-off is the lack of individual

control that results from participation in a program that pools risk. This means that some beneficiaries will receive less than they would have if they had controlled their own money and not participated in the program; others, who experience misfortune such as disability, widowhood, or unexpected longevity, will do better than they would have done on their own.

An underlying premise of many Social Security reform advocates is that the risk-pooling nature of social insurance programs actually increases the likelihood of risk occurrence. They argue that if individuals know that risks leading to poverty in retirement—such as unforeseen longevity, inflation, and disability—are guaranteed to be allayed should they occur, they will not do everything in their power to prepare for these risks. There is a wide range of opinions concerning which and to what extent risks and uncertainties are controllable and the appropriate treatment of people who take advantage of the risk-mediating nature of the current system by insufficient preparation. Hence, evaluation and comparison require a conception of what level and type of risk protections should be part of Social Security policy and consideration of whether a given policy actually meets that standard.

Weighing Considerations to Determine the Best Social Security Policy

This final consideration recognizes the variation in subjective weights that different persons place on the 10 other areas of consideration. For example, some may believe that social considerations are less important than economic considerations, or vice-versa. Some place higher value on achieving adequacy in a Social Security program, whereas others find equity a more compelling consideration. Some believe equity means redistribution, but others believe it means proportionate returns. These value differentials determine how people weigh the importance of the above 10 considerations and thereby

synthesize a large amount of information into one decision about which Social Security policy is “best.”

Conclusion

Just as this evaluation and comparison framework began with considering the impact

that policy advocates’ subjective value bases and beliefs have on plan goals, it ends with similar subjective considerations of policy evaluators’ weightings of different areas of outcome consideration. **Hence, the framework emphasizes the role of fundamental beliefs and values in the Social Security policy debate, highlighting the risk that discourse among different parties may take place on entirely different philosophical planes. However, the Social Security debate is not solely a subjective one; this framework has presented some of the numerous and interrelated technical, economic, political, and administrative questions that need to be addressed in the process of fair and complete analysis and comparison.**

The framework also shows that people with the same value beliefs can arrive at different policy outcome predictions, whereas people with the same policy outcome predictions can arrive at entirely different valuations of Social Security policy options. **The interplay between complex beliefs and values is testimony to the potential shortcomings of any proposed “easy answers” to the resolution of Social Security’s finance issues. As this framework shows, in fair and comprehensive comparison and analysis, every Social Security policy reform, as well as the current system, must be held accountable to a number of hard questions.**

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