Article from:

The Actuary

September 1999 – volume 33 - Issue 7

Reform proposals

A framework for viewing Social Security proposals

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The U.S. Social Security debate in Washington has often deteriorated into shorthand code words that provide little information about the policy alternatives under consideration. One such code word is "crisis," and whether or not Social Security's financing situation is one. Another is "radical," implying that those who would have us seriously consider alternative structures to the current one are revolutionary. Yet another is "privatization." Use of such terms does little to inform the public about the issues.

Part of the Social Security debate now underway is about funding. The system currently runs largely on a pay-as-you-go (paygo) basis. The trust fund, with $800 billion in assets, may seem gargantuan, but the balance represents only about 20 months of benefit payments. Allowing for a safety cushion to get the system through economic downturns, Social Security is largely funded on a paygo basis. This dimension of the debate is not about having a fully funded system versus one run strictly on a paygo basis. Instead, proposals take a variety of positions along a spectrum from paygo to fully funded financing.

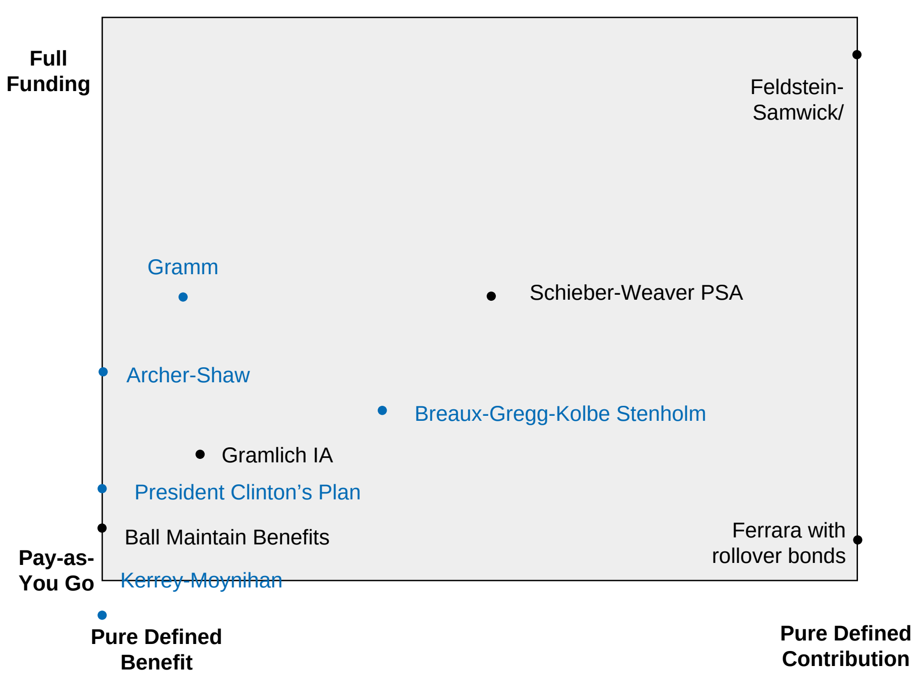
The debate also looks to the structure of the system and the process whereby workers earn and ultimately are paid their benefits. The question here is to what extent Social Security benefits should continue to be provided through the current defined-benefit structure versus one that has some defined-contribution element. Once again, the debate is not about absolutes but rather an almost infinite set of possible combinations, ranging from a system that is fully defined benefit to one that is fully defined contribution.

Review of the plans

The U.S. Social Security debate is about simultaneously resolving the discussion about each of these two dimensions that define a whole policy field of choices. The graph below shows how five proposals stand with regard to four criteria: full funding vs. paygo and defined benefit vs. defined contribution. Three proposals were put forward by the 1994-1996 Advisory Council on Social Security; two others have been discussed in various public arenas.

A plan put forward at the Advisory Council by Robert Ball, former Social Security Commissioner and long-time prominent advocate of the current program, called for some small additional funding over current levels but staying with a pure defined-benefit system. Another Advisory Council plan offered by current Federal Reserve Board member Edward Gramlich called for curtailment of the existing defined benefits that could be financed with the current OASDI payroll tax of 12.4%. These benefits would continue to be paid through the current defined-benefit system, somewhat more funded than the current system. In addition, the basic defined benefit would be supplemented by a defined-contribution plan that would be financed with contributions of 1.6% of payroll. In that regard, the combined system would be considerably more funded than under the Ball option and would provide the overwhelming majority of its benefit through a defined-benefit element and the residual through its defined-contribution element.

Location of Specific Proposals in the Policy Field of Social Reform Options



The Advisory Council plan that I co-developed with Carolyn Weaver, resident scholar of The American Enterprise Institute, called for half the contributions now supporting Social Security retirement benefits to be contributed to a defined-contribution account and the residual defined benefit system to be curtailed accordingly. Professors Martin Feldstein of Harvard University and Andrew Skinner of Dartmouth College have advocated a plan that would fully replace the current Social Security system with a funded defined-contribution system. Peter Ferrara of the Cato Institute has also advocated the immediate replacement of the current system with a defined-contribution system. At times, he has suggested that the immediate transition to the new system could be accomplished by granting recognition bonds to current participants in Social Security equal to the accrued value of their benefits at transition. If that were done, the immediate effect would be to create a defined-contribution system that is no more funded than the current paygo defined-benefit system. If the recognition bonds were rolled over as they matured, the system would continue to be largely financed on a paygo basis.

This same framework can be used to illustrate the proposals that are now on the table. President Clinton's proposal would retain the current pure defined-benefit structure of Social Security but increase its funding. Sens. Robert Kerrey (D-Neb.) and Daniel Patrick Moynihan (D-N.Y.) would move the system back to pure paygo financing and retain the defined-benefit status. Sens. John Breaux (D-La.) and Judd Gregg (R-N.H.) and Reps. Jim Kolbe (R-Ariz.) and Charlie Stenholm (D-Texas) would not only cut benefits back to live within the current payroll tax but carve a further benefit reduction out of the system to finance individual accounts for workers equal to 2% of covered payroll. They would fund the system to a much greater extent than under current law, but end up with a mixed defined-benefit and defined-contribution system.

The plan that has been put forward by Reps. Bill Archer (R-Texas) and Clay Shaw (R-Fla.) at first blush may seem more like the one put forward by Sen. Breaux and his cosponsors, but it really is not. This plan has evolved under the advice of Feldstein, so again, it might seem to be partially a defined-contribution plan.

The Archer-Shaw plan would finance 2% individual accounts using budget surplus initially. But the individual accounts would be invested in a portfolio dictated by the government — through managers picked by the government — and the assets would be converted to a mandatory annuity at retirement. The annuity financed through the individual account would reduce benefits provided directly through Social Security dollar for dollar. In other words, the worker is still guaranteed a current law benefit and derives no direct added benefit from the individual account program.

To me, this proposal looks like nothing more than a gambit to allow the government to control the investment of Social Security funds in private financial markets under the guise of investment being done by individuals. The worker will still receive a current law benefit, and in that regard the benefit is defined by the existing benefit formula — i.e., it is a defined benefit. This plan should result in somewhat more funding than the President Clinton's plan.

Sen. Phil Gramm (R-Texas) has offered a variant of the Archer-Shaw proposal; Gramm's plan also was developed with Feldstein's help. His plan calls for contributions of 3% of covered pay into individual accounts. Again, the funds would be invested in a dictated portfolio that is 60% stocks and 40% bonds. Workers could pick from a set of approved fund managers, but all would be investing in a fixed portfolio with strict government restrictions on assets to be included, administration and investment costs, and so forth. At retirement, the accumulated balance would by law be converted to an annuity. Social Security benefits from the existing system would be reduced by 80 cents for each dollar of annuity paid out of the individual account portion of the plan. The Gramm plan, like the Archer-Shaw plan, guarantees benefits equivalent to current law, and thus remains primarily a defined-benefit plan. It has a very small defined-contribution element in that the worker would, in practical terms, realize 20% of the accumulated annuity from the individual account. Twenty percent of a benefit that costs 3% of covered pay would be the equivalent of a separate defined-contribution benefit equal to 0.06% of pay.

There are a host of other proposals, some of them further to the northeast of the plans shown in blue on the accompanying graph (page 8). This forum is too restricted to review all of them, but those reviewed here should give the reader a sense of the nature of the debate that is unfolding in Washington this year. Using this framework still does not point to an optimal solution to the Social Security reform conundrum that we face. But it does begin to allow an analysis of reform options on the basis of specific sets of principles and assumptions. It is a much clearer way to think about the reform options than to talk about some of them privatizing the system while others do not, or some being radical while others are not.

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