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Fall 9-1-2001

## Social Security Reform Issues

Craig Copeland

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### Recommended Citation

Craig Copeland, *Social Security Reform Issues*, 58 Wash. & Lee L. Rev. 1203 (2001).

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# Social Security Reform Issues

Craig Copeland\*

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## *I. Introduction*

The Social Security program traditionally has been a strongly supported and popular program for providing income protection for workers and their dependents from old age, death, and disability. Social Security, by most accounts, has been a successful program, particularly in helping to lower the poverty rate for the elderly from 35.2% in 1959 to 10.2% in 2000.<sup>1</sup> Furthermore, according to Current Population Survey (CPS) data, 40.1% of the income that those age sixty-five or over receive comes from Social Security, while for those age sixty-five or over with incomes in the lowest three quintiles, at least 79.6% of their income is attributable to Social Security benefits.<sup>2</sup> However,

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\* Craig Copeland, Ph.D., is a Senior Research Associate and the Director of the Social Security Research Program at the Employee Benefit Research Institute.

1. See JOSEPH DALAKER, U.S. DEP'T OF COMMERCE, *POVERTY IN THE UNITED STATES: 2000*, at 4 (2001), available at <http://www.census.gov/prod/2001pubs/p60-214.pdf> (chart showing decline in poverty rate for elderly).

2. See KEN McDONNELL, *INCOME OF THE RETIRED POPULATION*, EBRINOTES (Employee Benefit Research Inst., Wash., D.C.), June 2001, at 5, 6 tbl.3 (table showing distribution of older population's income by income source). Evidence indicates that CPS data understates the

analysts currently project that the program will face a financial shortfall. This shortfall, which many argue could potentially lead to a sustained need to adjust benefit levels and tax rates if not reformed, has caused many observers to call for significant changes in the program to address the changing demographics of the population of the United States.

One of President George W. Bush's campaign platforms was the idea of adding individual accounts to the Social Security program. He proposed to create a commission that would fill in the details around the individual accounts by adjusting the "guaranteed" benefit portion and by making other potential benefit changes necessary to achieve the seventy-five year actuarial balance standard established by Congress. However, strong support still exists for the program in its present structure. Consequently, attempts to reform the program are likely to become contentious and drawn-out, particularly because there are approximately fifteen years before the projected annual costs of the program exceed its projected annual revenue.

This Article will examine the issues facing the Social Security program that have prompted discussions about reforming the program. In addition, it will investigate various potential reform proposals and the issues surrounding those ideas. It will then consider traditional types of reforms – benefit cuts and tax increases – and privatization.

## II. Factors Prompting Social Security Reform

According to the 2000 Trustees' Report of the Old-Age Survivors and Disability Insurance (OASDI) Program, the program is facing an actuarial deficit of 1.89% of taxable payroll under the report's intermediate assumptions.<sup>3</sup> The Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds expects that, starting in 2015, the level of revenue coming into the program will be less than the costs, and that payments to beneficiaries will exhaust the present build-up in the Social Security trust fund in 2037.<sup>4</sup> In addition, the Trustees project a sharp divergence in the cost and income rates of the program after 2015.<sup>5</sup> For example,

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private pension income of the elderly, and therefore overstates the percentage of income that the elderly receive from Social Security. Regardless, a majority of those age sixty-five or over, particularly the lowest-income elderly, still appear to receive a majority of their income from Social Security. See *infra* Appendix, Chart 1, at 1221.

3. See BD. OF TRUSTEES OF THE FED. OLD-AGE & SURVIVORS INS. & DISABILITY INS. TRUST FUNDS, THE 2000 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS 4 (2000) [hereinafter BOARD OF TRUSTEES], available at <http://www.ssa.gov/OACT/TR/TR00/index.html> (table on actuarial balance).

4. See *id.* at 3-4.

5. See *id.* at 171 tbl.III.A2 (table comparing income and cost rates).

the program's cost in 2000 is projected to be 10.34% of taxable payroll, while the income is projected to be 12.65%.<sup>6</sup> However, by 2070, the income rate is projected to be 13.32% compared to a cost rate of 19.24%.<sup>7</sup>

These statistics are projections, so one must keep the specific numbers in perspective, as they are moving targets. For example, in 1990 the projected actuarial deficit was 0.91% of taxable payroll.<sup>8</sup> This projected deficit reached a high of 2.23% in 1997 and subsequently declined to 1.89% in 2000.<sup>9</sup> This reduction occurred without any significant changes to the program.<sup>10</sup> The differences in the actuarial deficits resulted from changes in the assumptions and methods used in making the projections, the evaluation period used, and the better-than-expected performance in the economy over the last few years. Consequently, the assumptions used have come under scrutiny by some, but the resulting projections definitely provide a guide for the status of the program, particularly for the changing demographics due to the aging of the "baby-boom" generation.

The aging of the baby-boom generation is at the core of the fundamental issue facing the future of the program – the decreasing covered-worker-to-beneficiary ratio. In 1980, 3.2 covered workers existed for every beneficiary, and this ratio increased to 3.4 in 2000.<sup>11</sup> However, under their intermediate assumptions, the Trustees expect this covered-worker-to-beneficiary ratio to fall to 1.9 by 2070.<sup>12</sup> This projected decrease is the result of the increases in life expectancy and the lower birth rates of the generations following the baby-boom generation. In 1940, a sixty-five-year-old male could expect to live another 12.7 years, whereas in 2000 a sixty-five-year-old male is expected to live another 15.8 years.<sup>13</sup> In addition to the longer life expectancy, a larger

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6. *Id.*; see *infra* Appendix, Chart 2, at 1222.

7. *Id.*

8. See *id.* at 195 tbl.IIID1 (table on long range actuarial balances); see also *infra* Appendix, Chart 3, at 1223.

9. *Id.*

10. One could consider the elimination of the earnings test for those at the normal retirement age or older during this period to be significant. However, due to the actuarial adjustments that the program has established, this change did not impact the projected actuarial balance of the program.

11. See BOARD OF TRUSTEES, *supra* note 3, at 122 tbl.IIF19 (table on OASDI covered workers); see also *infra* Appendix, Chart 4, at 1224.

12. *Id.*

13. See C. EUGENE STEUERLE & JON M. BAKIJA, *RETOOLING SOCIAL SECURITY FOR THE 21ST CENTURY: RIGHT & WRONG APPROACHES TO REFORM* 41 tbl.3.1 (1994) (table showing distribution of historical and projected improvements in life expectancies). The Trustees' life expectancy assumptions changed significantly in the 2000 report to reflect the increasing life expectancies of the elderly, causing a change in the actuarial balance of approximately 0.10% of taxable payroll. See BOARD OF TRUSTEES, *supra* note 3, at 4. This recalculation increased

percentage of individuals will survive to the age of sixty-five. Fifty-three percent of males who were twenty-one years in 1896 survived to age sixty-five.<sup>14</sup> Analysts expect this number to increase to 76.0% for those who turned twenty-one in 1956.<sup>15</sup>

Another issue surrounding the Social Security debate is the present build-up in the OASI and DI trust funds. The 2000 Trustees' report indicates these assets will reach \$3,034.7 billion (constant 2000 dollars) by 2019.<sup>16</sup> These trust fund assets plus the program's revenues are expected to be sufficient to pay current law benefits through 2037.<sup>17</sup> However, the assets in the trust funds are U.S. government special issue treasury bonds. Therefore, when these assets are needed, the federal government will have to cut spending elsewhere in the budget, raise taxes, or issue more debt to the public to fulfill these obligations to the Social Security program.

Some view this build-up in the trust fund as a negative factor, because, until recently, the government was spending the assets in the trust fund for other federal programs and leaving IOUs in the trust funds. Some argue that this practice has allowed federal government spending to increase faster than it otherwise would. They argue that the government should divert the trust fund assets to assets other than government treasuries. This diversion would prevent the government from spending the money for any programs other than Social Security and would eliminate the need to incorporate the redemption of the special issue treasury bonds into the budget. Furthermore, critics of the trust funds also argue that the trust funds give a false sense of security for the program, as taxpayers ultimately are responsible for the redemption of the bonds. Therefore, one should evaluate the total tax impact of a reform, which includes changes in federal income taxes as well as payroll tax changes.

Ideology is also a strong factor in the discussions about the reform of Social Security. The increased sponsorship in the private sector of defined contribution pension plans relative to defined benefit plans and the rapidly increasing stock market created a growing acceptance and expectation by individuals and lawmakers that individuals should be responsible for their

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the further life expectancy of a male turning sixty-five in 2000 to 15.9 years and from the 17.5 years projected in the 1999 Board of Trustees' report to 18.1 years in the 2000 report for male turning sixty-five in 2040. *See id.* at 63 tbl.II.D2 (table on life expectancy); BD. OF TRUSTEES OF THE FED. OLD-AGE & SURVIVORS INS. & DISABILITY INS. TRUST FUNDS, THE 1999 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS 63 tbl.II.D2 (1999), available at <http://www.ssa.gov/OACT/TR/TR99/index.html> (table on life expectancy).

14. *See* STEUERLE & BAKJA, *supra* note 13, at 41 tbl.3.1 (table on life expectancy).

15. *See id.*

16. In year 2000 dollars, the trust fund is projected to contain \$6,047.6 billion by 2024. *See* BOARD OF TRUSTEES, *supra* note 3, at 179 tbl.III.B2 (chart showing trust fund estimates).

17. *See id.* at 4.

retirement savings. However, there are also those who believe that individuals should not incur the risks of investing in the stock market and point to the recent tremendous decline in stock market indexes for support. While stocks have traditionally outperformed other types of investment vehicles in the long run, short-term swings in market values, as the United States experienced during late 2000 and early 2001, can affect stocks significantly. These swings can greatly alter individuals' retirement income depending upon whether they are eligible for Social Security benefits at the top or bottom of the swings. Critics of individual accounts argue that the government (all taxpayers) – not the beneficiaries – should face this risk. The program instead should retain its defined benefit structure.

### *III. Types of Reform*

The Social Security program's most recent reforms have involved adjusting the basic benefit formula and eligibility ages or raising the payroll tax to cover the present level of benefits. In the past, a tax increase was an easier sell because the program added benefits or faced an immediate inability to pay benefits, as happened in 1983. Tax increases are a much more difficult sell when the "crisis" is fifteen years or thirty-seven years off (depending upon one's perception of the "crisis" date) and when there is talk of cutting benefits. Yet, if real income continues to increase as the Trustees' Report projects, then after-tax income could still increase despite an increase in the payroll tax. Thus, a tax increase would not necessarily make individuals worse-off after taxes in the future. One drawback of tax increases is that pay-back ratios and rates of return would become even lower for future generations, who already are experiencing declining rates of return due to the changing demographics and past tax increases.

The other major change to Social Security during 1983, aside from payroll tax increases, was the increase in the normal retirement age. A compelling reason for this adjustment is that longevity has increased steadily since the inception of the program, but the normal retirement age has not changed. Consequently, beneficiaries on average were collecting more years of benefits without working any more years. However, a higher normal retirement age could be quite burdensome for those workers in strenuous jobs that require a great deal of lifting or standing, as it is difficult for them to work in their later years. This issue would plague any future increases in the normal retirement age. Yet, as the percentage of white-collar jobs increases and the ratio of workers to beneficiaries continues to decline, the increase in the retirement age is an incentive for more people who can work to remain employed. Thus, the system benefits in two ways – beneficiaries wait longer to collect benefits, and they continue to pay payroll taxes.

Another widely discussed traditional reform is the adjustment of the consumer price index (CPI), used to index benefits, to counteract the effects of inflation. The CPI has been criticized for overstating the increase in prices in the general economy because, as prices change, consumers' expenditure priorities change in a way the CPI cannot fully capture. However, the goods that the elderly typically buy are not those that are easily interchangeable with other goods, such as food and housing. In addition, the elderly on average spend more money on health care than those under age sixty-five, and health care inflation has been steadily higher than the overall CPI. Thus, the overestimate of the CPI may not apply as well to the elderly as to those under age sixty-five. Therefore, under this type of reform, beneficiaries are likely to face continually declining real benefits as they become older.

Increasing the retirement age and adjusting the CPI have been widely-discussed ways to cut the benefits now promised in law, but various other ways to cut benefits are available.<sup>18</sup> A reason to consider reform options that cut benefits is that, as the economy grows, the current benefit formula increases the real benefits that future generations will receive. Consequently, beneficiaries will enjoy the proceeds of the increased growth they helped produce while they were working. To understand the magnitude of these increasing benefits, a 10% reduction in the projected benefits for average wage workers would cause the average wage worker's real benefit in 2010 to be virtually identical to its 2000 level. A 20% reduction in future benefits would allow the average wage worker to have the same real benefit level by 2030 as those retiring in 2000, and a 30% reduction would return the average wage worker's benefit to its 2000 level by about 2045.<sup>19</sup> Thus, in one sense, a future benefit reduction is not necessarily a cut in benefits. However, cutting benefits lowers beneficiaries' return from the program, and the present formula was established because it was considered important that the living standards of future retirees should not continually fall behind that of the rest of the economy. Otherwise, the indexing of benefits to prices instead of to wage growth would be a mechanism that could greatly reduce the program's projected funding shortfall. Benefit reductions that allow for increasing real benefits exist, yet the benefits would not be as large as what the law currently promises.

A second reform option is the collective investment of trust fund assets in financial instruments other than special issue treasury bonds, particularly

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18. Other options include increasing the number of years used to calculate the benefit, adjusting the bendpoint percentages downward, and indexing the benefit increases by a fraction of the growth in wages instead of by all of the growth in wages.

19. These are calculations derived from using the projected real benefits for beneficiaries retiring at age sixty-five and earning the average wage for their entire working years. See BOARD OF TRUSTEES, *supra* note 3, at 185 III.B5 (table showing average earnings of persons retiring at age sixty-five using constant year 2000 dollars); see also *infra* Appendix, Chart 5, at 1225.

in equities. This reform could accomplish two tasks. First, equities have experienced historically higher rates of return than treasury bonds. The trust fund could garner more income from these higher returns. Second, the federal government would not be faced with as large an amount of assets needed to be incorporated into the federal budget with the redemption of special issue treasury bonds for the Social Security program.<sup>20</sup> Under this scenario, Social Security could also use the trust funds to indefinitely accumulate additional assets in order to pre-fund future benefits, making the program more closely resemble a true defined benefit plan.

While investment in equities is likely to achieve higher rates of return in the long-term future, the plan comes with additional risk. The stock market has experienced periods of almost no growth, such as the early 1970s, and periods of extremely high growth, such as the late 1990s. Consequently, the trust fund could lose money during some periods; however, prudent management of assets could alleviate this problem.

The potential for managing assets that a government agency collectively holds is troubling for many because the federal government will have some stake of ownership in private enterprises. These people question whether the government will make investment choices based on political reasons rather than on the economic performance of a company. For instance, the government might refrain from investing in companies that produce politically unfavorable but legal products, such as cigarettes, guns, and alcohol. Another backdoor form of regulation also could occur if the government is allowed to vote in shareholder elections. If so, the federal government would have the potential to influence public companies' behavior in ways that would not help such companies' performance or serve their long-term best interests, which would potentially defeat the purpose of investment in equities. Furthermore, the government could face conflict of interest concerns if it simultaneously owned stock in a company and pursued governmental action, such as an anti-trust suit, against the company.

While evidence from state pension plans indicates that some investment choices based on political reasons turned out badly,<sup>21</sup> other evidence shows that state-run defined benefit pension plans have had similar investment performances to private company pension plans.<sup>22</sup> The Social Security program

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20. If the government invests only a portion of the Social Security trust fund's assets in investment instruments other than the special issue treasury bonds, then this decision would not eliminate the issue, but only make it less significant.

21. See DANIEL J. MITCHELL, WHY GOVERNMENT CONTROLLED INVESTMENT WOULD UNDERMINE RETIREMENT SECURITY, THE HERITAGE FOUNDATION BACKGROUNDER (Heritage Found., Wash., D.C.), Feb. 5, 1999, at 1, 5-9, available at <http://www.heritage.org/library/backgrounder/bg1248es.html> (illustrating risks of politically driven investment choices).

22. See Alicia H. Munnell & Annika Sunden, *Investment Practices of State and Local Pension Funds: Implications for Social Security Reform*, in PENSIONS IN THE PUBLIC SECTOR



can design systems that mitigate political influences in investment choices through the use of index funds and by not allowing the government to vote in shareholder elections. However, the long-term question for the success of the collective investment becomes whether legislators will leave the system alone or whether they will move to change it during a political movement against a company or product.

The third reform option type is privatization. Privatization generally refers to any proposal that involves creating individual accounts for each covered worker or for workers born after a certain year. In a true privatization of the program, all payroll tax revenue would become contributions to workers' individual accounts. The government's role would be limited to verifying contributions and overseeing the institutions administering the accounts. Benefit determination would depend upon the contributions to and the investment performance of the account. However, Congress has not discussed any true privatization proposal. Most proposals are partial privatization programs in which an individual account is carved out of or added onto the present program and the present law benefit is scaled back or made into a flat benefit.

This type of reform option has many of the same benefits as collective investment of the trust fund assets. Privatization would allow the investment in equities to garner the traditionally higher rates of returns and would take the assets out of special treasury issue bonds, which consequently would stop the accumulation of assets in the trust funds that the government would need to redeem in the future. It also establishes prefunding for some portion of benefits, reducing the future liabilities needed to be paid out of current payroll taxes. Partial privatization does have one huge difference from collective investment of the trust funds – individuals, not the government, make the investment choices.

Because investment in equities alone cannot ensure a financially sound Social Security program, the government will likely use some combination of these reform options if reform does progress. Concerns about success, fairness, and feasibility surround each of these reform types. The remainder of this Article will discuss these issues for the different reform options.

#### *IV. Concerns When Considering Reform Options*

As the government considers Social Security reform, various concerns arise about the soundness and future success of different reform proposals. For example, any type of proposal that uses equities, either for individual accounts or collectively, has to provide support for a future equity return and should acknowledge and explain the risks that workers and beneficiaries

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153, 177 (Olivia S. Mitchell & Edwin C. Hustead eds., 2001) (advocating public pension funds).

undertake. Furthermore, if the government introduces individual accounts, it must determine how it will administer the accounts, what investment choices it will allow, and what the costs will be. The government would most likely also need to adjust benefits under a partial privatization reform, which implicates the fairness, adequacy, and redistribution the program can achieve. Finally, the sustainability of the program after the reform and the ability to pay for the transition to a new system are important factors in evaluating reform options.

### A. Equity Return Rate

A critical factor in the success of any reform proposal using equity investment is the rate of return these investments will receive in the future. The historical equity premium – the rate of return on stocks above the return on treasury bonds – has been 3.5%.<sup>23</sup> Before the recent sharp decline in the stock market, the very high price-earnings ratios that existed led some analysts to suggest that the equity premium will probably not continue to be this high over the next seventy-five years.<sup>24</sup> In fact, in the 1999 Technical Panel on Assumptions and Methods Report to the Social Security Advisory Board, it is recommended that the Social Security actuaries reduce the equity premium from 4% to 3% when they evaluate proposals that involve equity investments.<sup>25</sup> Other analysts argue that the likely equity rate of return will have an equity premium from 0.5% to 1.5% if the trustees' projected economic growth rate is accurate.<sup>26</sup> However, Dr. Peter Diamond computed that the stock market would need to decline by 35-45% in real value, calculated at the 1998 level, in order to sustain a future equity rate that equals the historic rate.<sup>27</sup>

While evidence increasingly indicated that the future equity rate could not meet its historic rate when the equity market's price-to-earnings ratio was

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23. Peter A. Diamond, *What Stock Market Returns to Expect for the Future?*, in ESTIMATING THE REAL RATE OF RETURN ON STOCKS OVER THE LONG TERM 20 (2001), available at <http://www.ssab.gov/estimated%20rate%20of%20return.pdf>. (paper presented to Social Security Advisory Board) (table on equity premiums).

24. See IMPLICATIONS OF INVESTING SOCIAL SECURITY FUNDS IN THE U.S. STOCK MARKET, EBRI NOTES (Employee Benefit Research Inst., Wash., D.C.), Sept. 1999, at 2-3 (summarizing studies by J.P. Morgan and Morgan Stanley Dean Witter economists concluding equity premium between 1% and 3% is likely).

25. SOC. SEC. ADVISORY BD., 1999 TECHNICAL PANEL ON ASSUMPTIONS AND METHODS REPORT TO THE SOCIAL SECURITY ADVISORY BOARD 11 (1999), available at [http://www.ssab.gov/Rpt99\\_TOC.html](http://www.ssab.gov/Rpt99_TOC.html) (equity premium recommendation).

26. See DEAN BAKER & MARK WEISBROT, SOCIAL SECURITY: THE PHONY CRISIS 95-96 (1999) (stating expected rate of return consistent with 1.5% growth rate in economy).

27. See PETER A. DIAMOND, WHAT STOCK MARKET RETURNS TO EXPECT FOR THE FUTURE?, AN ISSUE IN BRIEF (Ctr. for Ret. Research, Chestnut Hill, Mass.), Sept. 1999, at 1, 3 (calculating required percentage decline needed to justify 6-7% return).

at record high levels, the price-to-earnings ratio has subsequently fallen substantially, potentially allowing the historic rate to meet the much lower new levels. Yet, some still argue that the growth rate in the economy that the OASDI Trustee's report projected is significantly lower than the past rate of growth, which historically coincided with the rate of return in the equity market.<sup>28</sup> Thus, an inconsistency exists in these assumptions; one should expect that if the projected growth rate occurs, the equity rate would be lower. However, economic growth and equity return do not correlate perfectly. Consequently, one cannot readily determine the correct rate. Policies relying solely on high market returns could potentially end up below advertised value.

Regardless of the ultimate average rate of return, the rate will not be the same every year. The rates will periodically be either lower or higher than the historic average rate. Consequently, when assessing policies that use equities, using a deterministic rate of return for policies every year does not give a clear picture of the likely results. The additional uncertainty of equities makes predicting the soundness of the program seventy-five years in advance even more difficult. In addition, no reasonable equity rate will eliminate the present shortfall, but the choice of rates definitely will affect the attractiveness of such proposals.

#### *B. Administrative Issues of Individual Accounts*

The potential introduction of individual accounts brings up a host of issues on the administration of such accounts. For example, the plan sponsors and administrative vendors of defined contribution pension plans offered through employers have numerous tasks to perform, including the following:

- (1) Enrolling new beneficiaries,
- (2) Calculating required contributions,
- (3) Sending contributions to accounts,
- (4) Providing investment education,
- (5) Overseeing participant investment selection and fund transfers,
- (6) Managing funds,
- (7) Calculating losses incurred as a result of mistakes and compensating participants for financial losses due to those errors,
- (10) Documenting compliance with laws and regulations,
- (11) Processing benefit claims, and
- (12) Purchasing annuities.

Consequently, how an individual account system deals with these tasks – who must perform each task and how much they will do – will play an important

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28. See BAKER & WEISBROT, *supra* note 26, at 90 (stating inconsistency between projected future growth of economy by trustees and historical return to equities as future return to equities).

role in the feasibility and cost of its administration. Because some of these tasks are less important than others, this section will focus on the major factors.

*How would the government make account contributions and credit investments to individual accounts?* Analysts have discussed three such proposals: the current payroll tax structure approach; a 401(k) approach through employees; and an individual retirement account approach through individuals.

Under the current payroll tax structure, virtually all employers report quarterly to the IRS the aggregate amount they have withheld or collected in federal income taxes and payroll taxes. However, they do not reconcile the aggregate amounts with individuals' earnings until early the next year, when they produce W-2 forms that they mail by the end of January. The Social Security Administration then takes a few months to credit an individual's earnings record with the previous year's earnings. For instance, the Administration will not record January earnings to the individual's earnings record until approximately sixteen months later. While this is fine under the current system in which the individual invests no funds, in an individual account system the sixteen-month float period of some earnings could significantly impact the account's investment performance.

Analysts have suggested alternative solutions in which employers would face an increase in reporting duties. These employers would treat the contributions as if they offered a defined contribution plan. The employer would have to determine monthly each employee's earnings and contributions to their individual accounts, and then either deposit the money in a central clearance agency or send it to the actual fund administrators of the employee's choice. However, less than half of all wage and salary workers presently participate in a pension plan.<sup>29</sup> Thus, many employers would face a new and potentially costly administrative burden.

The Employee Benefit Research Institute commissioned a survey of small employers on their attitudes toward Social Security individual account administration.<sup>30</sup> While 80% of the small business decision makers were either favorable (57%) or neutral (23%) towards individual accounts, 48% had nega-

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29. SEE CRAIG COPELAND, RETIREMENT PLAN PARTICIPATION: FULL-TIME FULL-YEAR WORKERS AGES 18-64, EBRI NOTES (Employee Benefit Research Inst., Wash., D.C.), Jan. 2001, at 1, 1 (examining retirement plan participation for full-time, full-year wage and salary workers).

30. See KELLYA. OLSEN & DALLAS L. SALISBURY, SMALL EMPLOYER SURVEY ON INDIVIDUAL SOCIAL SECURITY ACCOUNT ADMINISTRATION, EBRI NOTES (Employee Benefit Research Inst., Wash., D.C.), Apr. 1999, at 1-4 (discussing small employers' views on administering individual accounts). Matt Greenwald & Associates, Inc. conducted the survey of 500 small (5-100 employees) businesses in November of 1998. *Id.* The survey sampled small-business decision makers who are less likely than large employers to outsource payroll administration and presumably would be more sensitive to an employer mandate. *Id.* In fact, only four out of ten survey respondents used an external payroll service. *Id.*

tive feelings about administering the accounts.<sup>31</sup> Of those who gave a maximum dollar amount of the costs that they would be willing to accept and still support individual accounts, approximately 60% would pay only one thousand dollars or less annually, 32% would pay between one thousand dollars and five thousand dollars, and 7% would pay over five thousand dollars.<sup>32</sup> In a separate survey of small employers, 45% of those not offering a pension plan cite the uncertainty of revenue as a major reason for not offering a plan.<sup>33</sup> Furthermore, 33% of those not offering a plan say that the high cost of setting up and administering a plan is a major obstacle.<sup>34</sup> Consequently, if a Social Security reform program forces employers to administer these accounts, many small employers would face tasks that cost or revenue concerns had deterred them from undertaking voluntarily.

A final alternative is an individual or IRA approach. Under this alternative, individuals would be responsible for depositing their own money with a financial institution or mutual fund provider. While this approach could eliminate the float issue, some analysts point out the difficulty of enforcing such an approach, as well as the likely greater expense due to each individual setting up a separate account. Group plans have an advantage, for they can negotiate a lower per-person fee.<sup>35</sup>

Each approach has its drawbacks, but the current payroll structure appears to maximize the amount each individual has in their account by keeping costs low.<sup>36</sup> Failure to control the costs of administering these accounts would affect benefits significantly. For example, plans that use the higher bound of administrative costs instead of the lower bound would reduce total annual

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31. See *id.* at 2 (noting employers' views on administering individual accounts).

32. See *id.* at 2-4 (noting maximum amount of administrative costs employers would accept). Approximately 30% did not know the amount they would be willing to spend and still support the individual accounts. *Id.*

33. See DALLAS L. SALISBURY ET AL., RETIREMENT CONFIDENCE SURVEY 2000: INCLUDING RESULTS FROM THE RCS MINORITY SURVEY AND THE SMALL EMPLOYER RETIREMENT SURVEY, EBRI ISSUE BRIEF (Employee Benefit Research Inst., Wash., D.C.), June 2000, at 1, 13 (listing reasons small employers do not offer retirement plans).

34. See *id.*

35. See KELLY A. OLSEN & DALLAS L. SALISBURY, INDIVIDUAL SOCIAL SECURITY ACCOUNTS: ISSUES ASSESSING ADMINISTRATIVE FEASIBILITY AND COSTS, EBRI SPECIAL REPORT AND ISSUE BRIEF (Employee Benefit Research Inst., Wash., D.C.), 1998, at 1, 17 (noting difficulties with IRAs).

36. Depending upon the services offered, even a centrally administered system could be costly at the outset of the program. A study by the Social Security Administration estimated that the first year's ongoing administrative costs could amount to 95-400 basis points of assets from a 2-percentage point individual account system, although they predict that this cost as a percent of assets will decline as the system matures. LAWRENCE E. HART ET AL., U.S. SOC. SEC. ADMIN., SSA'S ESTIMATES OF ADMINISTRATIVE COSTS UNDER A CENTRALIZED PROGRAM OF INDIVIDUAL ACCOUNTS 3 (Soc. Sec. Admin., Jan. 9, 2001), available at <http://www.ssa.gov/policy/pubs/IApaper.pdf>.

benefits by as much as 23%.<sup>37</sup> While this approach appears to best address the important administrative cost issue, it still does not address the issue of the extended float period.

*How many investment services?* The service features that have a significant effect on the costs of these accounts include the frequency of permitted fund transfers between investment options or other approved savings plans, access to plan and investment information, and the number of investment options offered. More services directly lead to more costs but provide more flexibility in investment choices. Therefore, a savings plan must balance the two. For example, a system with numerous investment options, daily inter-fund trades, and twenty-four hour phone service would be very expensive to administer. One of the reasons the federal employees' Thrift Savings Plan (TSP) is a low cost plan is that it has limited choices of index funds, biannual account statements, and monthly interfund transfers. The TSP is much different than the 401(k) plans in which many employees presently participate, which offer managed funds, quarterly statements, and daily interfund transfers.<sup>38</sup>

*Who regulates and who provides investment education?* A new system of individual accounts would necessitate a new level of regulation, as the influx of new investors would make the climate favorable for fraud. The government could use a number of methods to regulate these accounts. These methods include registering participants, establishing and protecting beneficiary and participant rights, setting and enforcing standards for reporting and disclosure, balancing investment choice with risk by setting investment guidelines (such as by limiting the percentage a portfolio devotes to a particular asset class), ensuring that participants adhere to the guidelines, and regulating withdrawals.<sup>39</sup> Predicting whether regulation will be sufficient or too burdensome is difficult, but if the regulation of employer-sponsored plans is a guide, regulators are likely to be active in the regulation of individual accounts. Furthermore, one can expect active regulation because the government would

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37. See CRAIG COPELAND ET AL., SOCIAL SECURITY REFORM: EVALUATING CURRENT PROPOSALS, EBRI ISSUE BRIEF (Employee Benefit Research Inst., Wash., D.C.), June 1999, at 10-11 (chart showing calculation of benefits at varying amounts of administrative costs); see also *infra* Appendix, Chart 6, at 1226.

38. For example, the addition of managed equity funds would add costs to an individual account system. The Investment Company Institute reported that the average operating expense ratio for equity mutual funds in 1998 ranged from 70 basis points for large funds (with \$5 billion or more in assets) to an average of 139 basis points for small funds (with assets of \$250 million or less). See JOHN D. REA ET AL., OPERATING EXPENSE RATIOS, ASSETS, AND ECONOMIES OF SCALE IN EQUITY MUTUAL FUNDS, PERSPECTIVE (Inv. Co. Inst., Wash., D.C.), Dec. 1999, at 1, 2, available at <http://www.ici.org/pdf/per05-05.pdf> (calculating average operating expense ratio for equity mutual funds, by assets in 1998).

39. See OLSEN & SALISBURY, *supra* note 30, at 30-32.

feel responsible to pay for individuals' retirements if the accounts do not perform as planned.

While the costs of this regulation are not known, the placement of that burden will have important ramifications on the value of individual accounts. If the workers must pay, they will receive less benefits from the account. With government-imposed limits on the fees that administrators can charge and onerous regulation requirements, administrators may drop out of the market. The government could choose to subsidize the administrators for the costs of complying with regulations, which in turn could affect the federal budget or the defined benefit portion of the account. Whatever the choice, the impact could be significant.

Along with regulation, the influx of new investors calls for education on at least the basic aspects of investing. Many surveys have found that persons in the United States have low levels of investing knowledge. Therefore, workers need an education campaign, educational materials, and investing seminars to equip them with the knowledge to make wise investment choices. Further questions remain regarding who should provide this education – employers, administrators, or the government – and how much education they should provide.

### C. "Guaranteed" Benefits

Currently, a formula determines Social Security benefits. Based on this formula, a worker with a specific work record will receive a certain real benefit for the duration of the worker's life. Under the current formula, the addition of individual accounts will likely reduce the amount of real benefits, which are "guaranteed" because they result from a formula, not the investment performance of an individual account. The benefits from individual accounts could potentially exceed guaranteed benefits, but they also risk being significantly lower. Defenders of the present system argue that individuals should not expose themselves to this risk as they are not equipped to handle it. They also argue that a program should establish a basic level of benefits on which beneficiaries can rely during their retirement, instead of subjecting beneficiaries to the fluctuation of the stock market. Furthermore, the growing participation in defined contribution plans has already increased workers' exposure to the risks of the stock market. A projection of sources of retirement income for baby-boomers based upon this trend towards defined contribution plans shows a significant increase in income coming from "non-guaranteed" sources, such as defined contribution plans and IRAs.<sup>40</sup>

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40. See JACK VANDERHEI & CRAIG COPELAND, THE CHANGING FACE OF PRIVATE RETIREMENT PLANS, EBRI ISSUE BRIEF (Employee Benefit Research Inst., Wash., D.C.), Apr. 2001, at 14 (chart showing composition of estimated retirement wealth for males of normal retirement age who were born between 1936 and 1964); see also *infra* Appendix, Chart 7, at 1227.

However, current law does not guarantee that Social Security benefits will remain at their present level, creating what is called "political risk." Lawmakers have the ability to change benefit levels if they deem it necessary to do so. Supporters of individual accounts counter that accounts invested in equities would partially offset this political risk by having larger rate of return possibilities and by creating ownership of the account for beneficiaries. Consequently, lawmakers would have a reduced need, as well as reduced ability, to cut total benefits. While a partial privatization system would reduce but not eliminate political risk, introducing individual accounts would also create the additional risk of investment. Comparing the risks is virtually impossible, particularly when attempting to assess political risk.

#### *D. Redistribution, Fairness, and Adequacy*

The current benefit structure within the Social Security program replaces a higher percentage of income for lower income workers than for higher income workers. The program's architects intended to achieve some perceived level of adequacy in benefits. However, Social Security also attains fairness by allocating higher benefits to those who contribute more. Public recognition of the program's fairness and adequacy explains its popular support. Some studies show that redistribution between income groups is fairly neutral over workers' lifetimes: wealthier persons tend to live longer than less wealthy ones, which offsets the higher replacement rates for those with lower incomes.<sup>41</sup>

A movement to individual accounts would alter the present redistribution within the program. Under an individual account system, workers, regardless of their income, are likely to retain the full amount of the percentage going to the individual account. Thus, a smaller amount of the benefit will be subject to the formula that favors lower income workers.<sup>42</sup>

It is possible to adjust the guaranteed benefit in order to mitigate the lessening of the redistribution that would occur with a straight reduction. Possible adjustments include lowering the two higher bendpoints of the benefit formula and adding a minimum benefit that would ensure a certain income above some level. Whether these adjustments effectively offset the lessening of the redistribution from adding individual accounts will depend upon the magnitude of the adjustments. A potential downside to steep adjustments is

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41. See Adam Carasso et al., *Social Security Redistribution by Education, Race, and Income: How Much and Why*, in MAKING HARD CHOICES ABOUT RETIREMENT 12 (2001) (paper presented at Third Annual Conference of Retirement Research Consortium) (discussing redistribution by income quintiles).

42. See Kathryn L. Moore, *Redistribution Under a Partially Privatized Social Security System*, 64 BROOK. L. REV. 969, 969-70 (1998) (discussing redistribution under partially privatized system).



that higher income beneficiaries may determine that a large percentage of their benefit comes from the individual account even though they pay much more in taxes. Consequently, if they believe that the guaranteed portion of the benefit approaches a welfare program, they may withdraw their support for Social Security.

Social Security also faces redistribution and fairness issues with spousal benefits. Presently, spousal benefits redistribute income from two-earner couples to one-earner couples. The nonworking spouse in a one-worker couple receives 50% of the spouse's benefit at the normal retirement age and receives the spouse's full benefit if the working spouse passes away. Despite also qualifying for this benefit, both earners in a two-earner couple still pay payroll taxes and, depending upon the couple's earning levels, may receive nothing additional from their contributions beyond what a nonworking spouse would receive. A two-earner couple is also disadvantaged in that, upon death, one of the spouses is likely to receive smaller benefits than a nonworking spouse would. In addition, a spouse must be married for ten years before qualifying for benefits based upon the spouse's earnings.

Even without the addition of individual accounts, these benefit rules may no longer match the present demographics of the country, given the higher female labor force participation and divorce rates. In light of those demographic changes, the current benefit rules may actually lead to less effective poverty prevention. If individual accounts are added, spousal benefits would involve additional complexities, such as allocating individual account proceeds to the spouse after divorce. Consequently, Congress is likely to discuss the issue of spousal benefits regardless of the manner in which it reforms the program, or even in the absence of reform.<sup>43</sup>

#### *E. Probability of Actuarial Balance and Sustainability*

The Trustees' Report used to evaluate the Social Security program's finances relies upon an actuary model that is deterministic, meaning that each value is constant or follows a predetermined path to an ultimate value. However, the economy does not have the same economic values every year for the respective economic measures. For example, in a comparison of some generic traditional reforms and one similar to the Archer-Shaw proposal using different assumptions in which all have at least a zero actuarial balance deterministically, when they are analyzed stochastically all have less than a 50% probability of reaching the zero actuarial balance level with the exception of the Archer-Shaw type proposal under the most favorable assumptions.<sup>44</sup> Conse-

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43. See URBAN INST., SOCIAL SECURITY: OUT OF STEP WITH THE MODERN FAMILY 6-13 (Urban Inst. 2000) (discussing spousal benefits under present system).

44. See CRAIG COPELAND, SOCIAL SECURITY: NOT ALL REFORM APPROACHES ARE

quently, the achievement of actuarial balance deterministically does not necessarily guarantee actuarial balance over seventy-five years. Thus, reform programs need to take measures to increase the likelihood of attaining the seventy-five year actuarial balance standard.

One should evaluate reform systems based on the odds of a given system attaining actuarial balance in a given seventy-five year evaluation period and the odds of it continually reaching this standard. This sustainability is important, as the OASDI Trustees have projected that later years of the seventy-five year period will have significantly higher cost rates than income rates. Thus, each future evaluation period will gain a deficit year while losing a surplus year. Consequently, one reform goal should be to bring back together these diverging cost and income rate paths.

Individual account supporters argue that individual account proposals will achieve sustainability by decreasing future liabilities, whereas the present system is unsustainable without continuous tax increases or benefit cuts. Individual accounts could help attain sustainability by prefunding at least some of the future benefits through the individual account by reducing the claims for benefits from future worker cohorts. While prefunded individual accounts reduce future liabilities and most likely will replace some of the future guaranteed benefits, they do not necessarily assure sustainability as some level of guaranteed benefit will most likely still exist. Individual account proposals could face the same problems as those that retain the guaranteed benefits, but on a smaller scale.

In contrast, the current structure of Social Security benefit levels does not appear to lead to sustainability. If the Trustees' intermediate assumptions are correct, some reforms are necessary to place the program on sound footing. An increase in taxes will not ensure sustainability, as demographics could change again, causing liabilities to increase. However, measures such as indexing the normal retirement age to changes in longevity could automatically adjust for increased liabilities. Yet, automatically adjusting for poor economic performance without exposing workers to ever-increasing payroll taxes is difficult.

#### *F. Transition Costs*

The movement to individual accounts would mean a change in the financing structure of the program. This movement will impose costs, as it will divert some of the payroll tax dollars from current beneficiary benefits to workers' individual accounts. While the present system faces a funding gap of around \$3 trillion dollars regardless of any future reforms, the transition to

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EQUAL, EBRI NOTES (Employee Benefit Research Inst., Wash., D.C.), May 2001, at 5 (chart showing percentile of actuarial balances for various reform proposals); *see also infra* Appendix, Chart 8, at 1228.

individual accounts will require additional upfront revenues. An estimate of the transition costs of a proposal that uses a carve-out individual account, the original Gregg-Breaux-Kolbe-Stenholm bill, amounted to \$2.7 trillion.<sup>45</sup> Consequently, some type of funding- or benefit-cut measure is necessary to shift to an individual account system. One drawback is that this measure may not lead to immediate economic benefits for the country or to the account beneficiaries.

### *V. Conclusion*

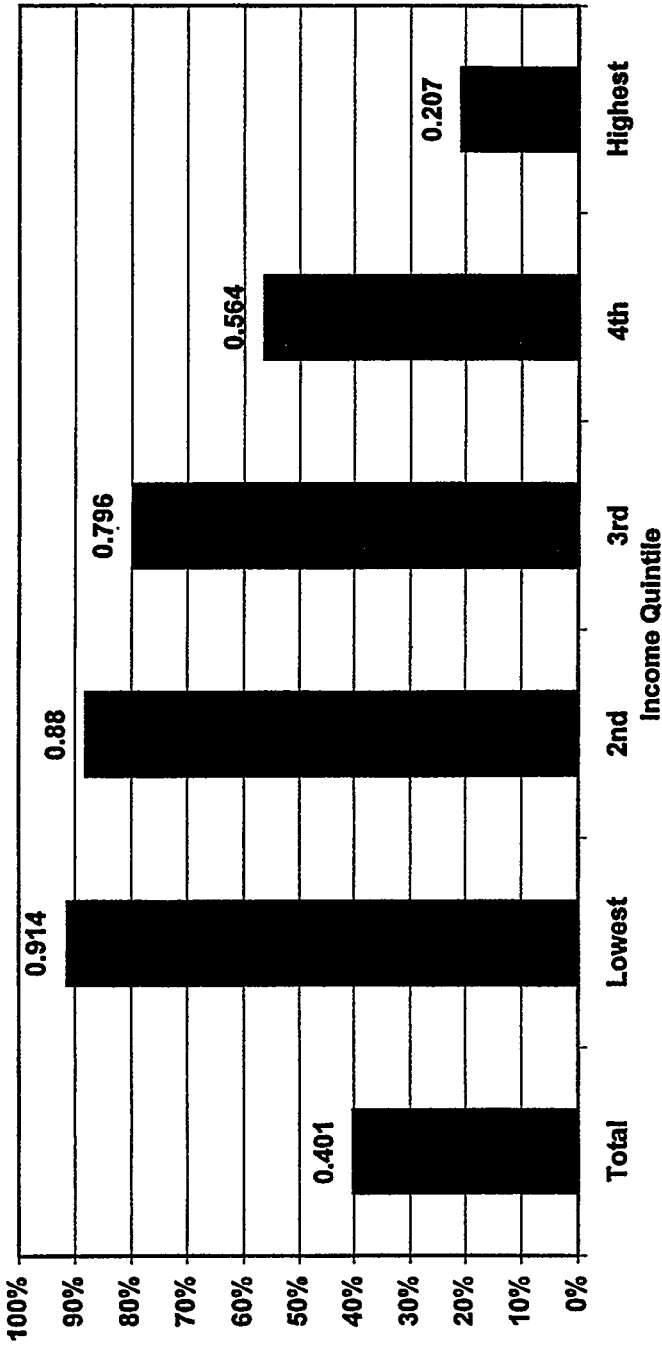
Social Security remains a very popular program and has been successful in helping to reduce the poverty rate for the elderly. However, analysts currently project it to have an actuarial deficit. Thus, a continuing debate exists over how to change the program so that it can meet its promises. The current system has some attributes that are worthy of preserving and perhaps are necessary to preserve, but as critics of the present structure point out, traditional reforms have historically left the program with a financial shortfall. These critics contend that a new structure using individual accounts can reduce the future liabilities attributable to the payroll taxes by prefunding part of the benefits and by garnering additional revenue from the higher returns available in the equity market. Yet a movement to such a system will impose transition costs and will alter the beneficiaries' exposure to risks, the redistribution of income within the program, and the adequacy of benefits. Furthermore, the design of these accounts will significantly impact their cost and their ability to "solve" the funding issue of Social Security. While prefunding with the collective investment of assets could achieve many of the same goals as individual accounts, it has not gained momentum in the policy arena due to the concern surrounding government ownership of private enterprises. Finally, whatever one's stance on Social Security reform, changes at some point are necessary for Social Security to remain financially sound well into the future. Therefore, careful consideration of these issues is a must.

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45. See SYLVESTER J. SCHIEBER & JOHN B. SHOVEN, *THE REAL DEAL: THE HISTORY AND FUTURE OF SOCIAL SECURITY* 366 (1999) (estimating costs of transition for various reform proposals).

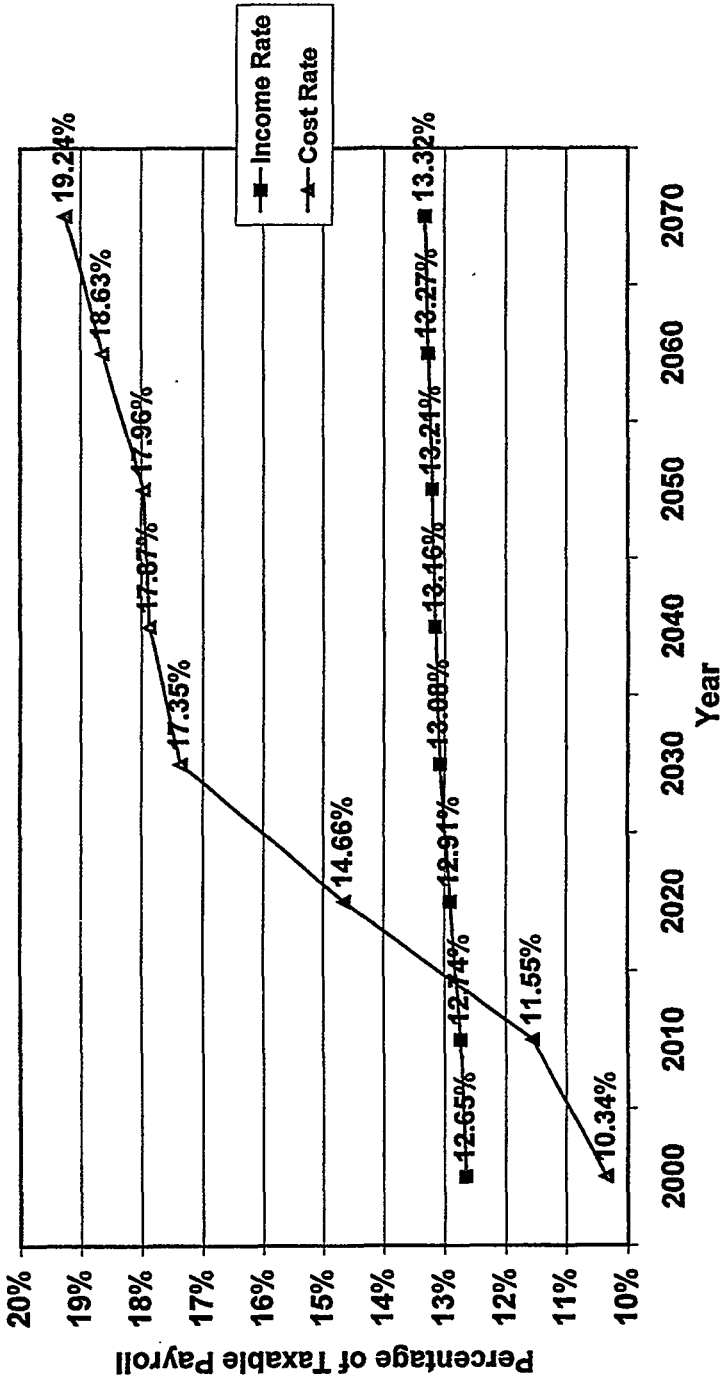
Appendix

**Chart 1: Percentage of the Income of the Elderly Coming from OASDI Benefits, by Quintile, 1999**



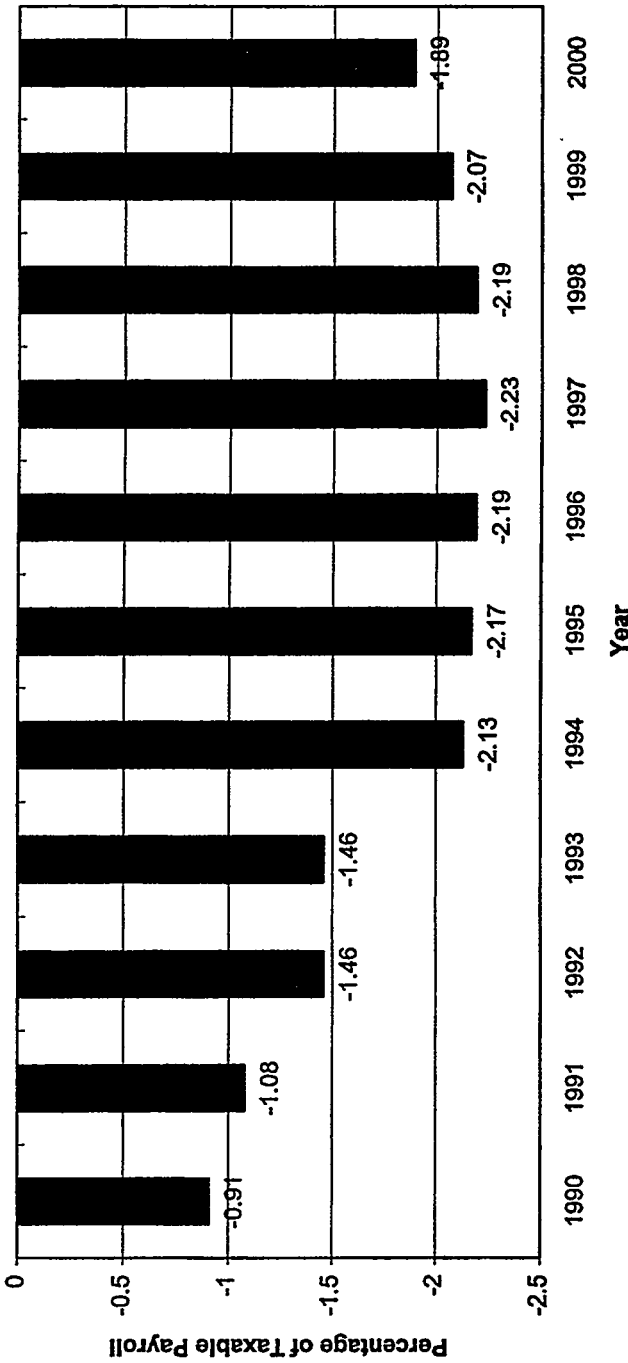
Source: Ken McDonnell, Income of the Retired Population, EBRI Notes (Employee Benefit Research Inst., Wash., D.C.), June 2001, at 5, 6 tbl.3

**Chart 2: Income Rates Versus Cost Rates for OASDI Intermediate Assumptions, 2000-2070**



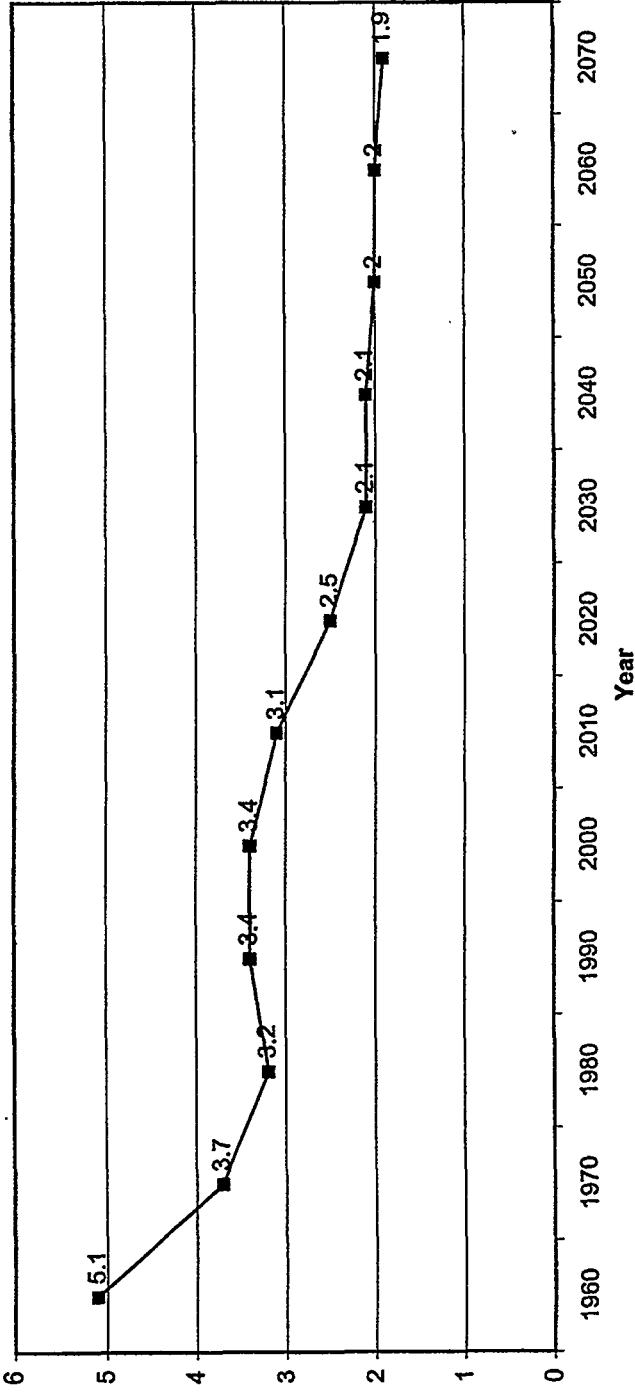
Source: Bd. of Trustees of the Fed. Old-Age & Survivor Ins. & Disability Ins. Trust Funds, The 2000 Annual Report of the Board of Trustees of Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds 171 tbl.III.A2.

**Chart 3: Long-Range Actuarial Balance for the OASDI Program Using Intermediate Assumptions, 1990-2000**



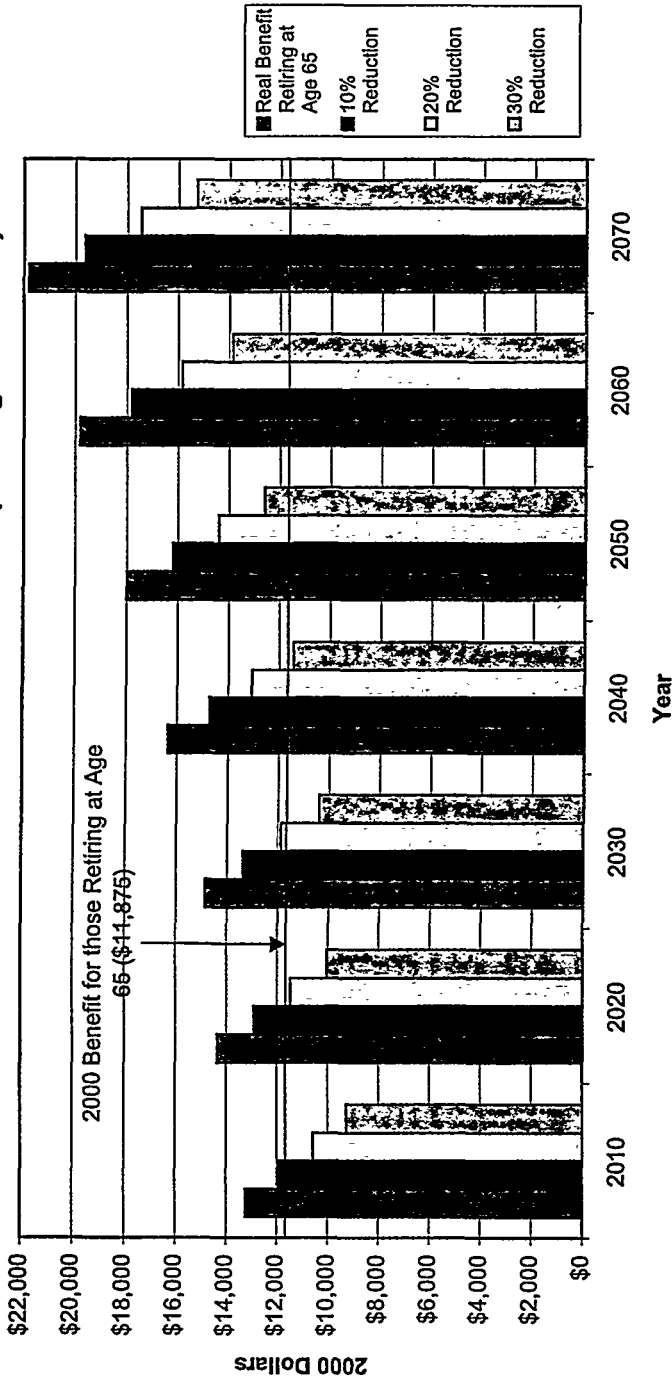
Source: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, The 2000 Annual Report of the Board of Trustees of Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds 195 tbl.III.O1.

**Chart 4: Covered Worker/OASDI Beneficiary, 1960-2070**



Source: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, The 2000 Annual Report of the Board of Trustees of Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds 122 tbl.II.F.19.

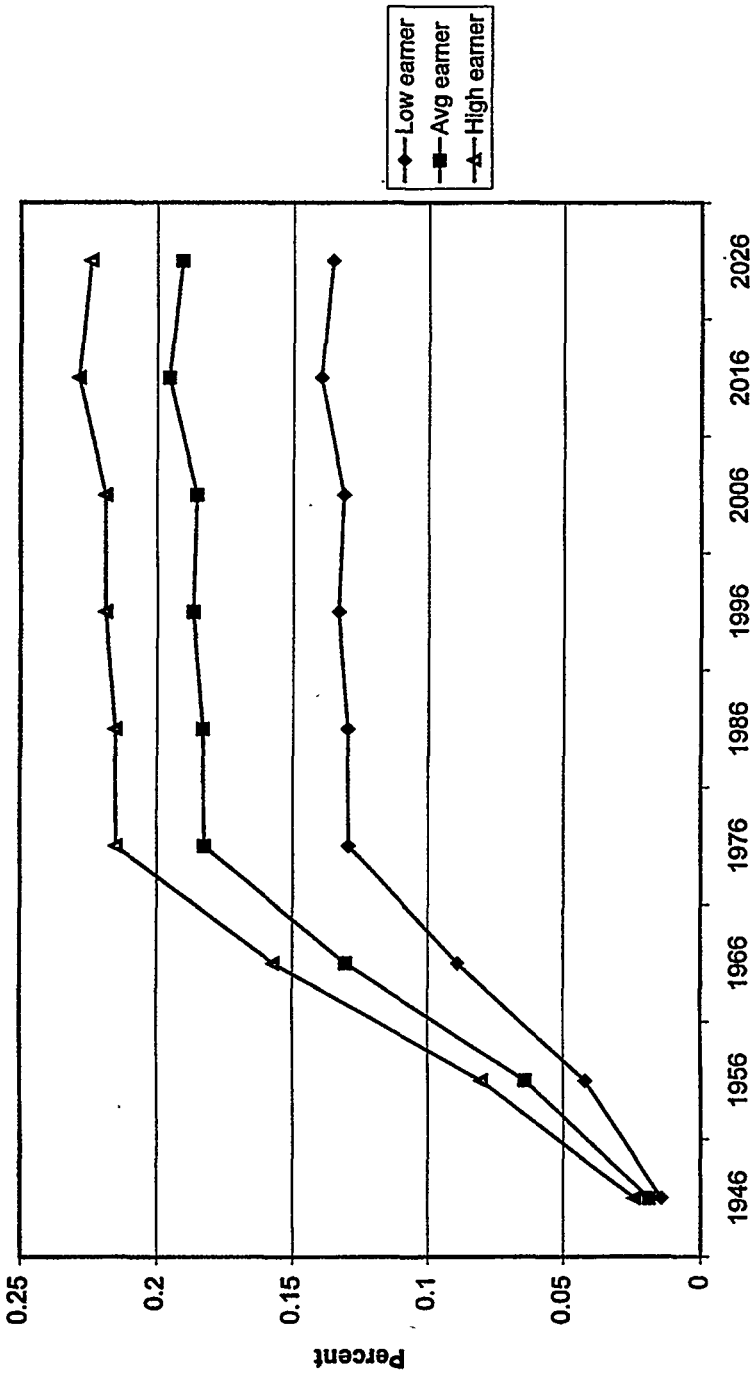
**Chart 5: Real Benefits (2000\$'s) for Those Retiring at Age 65 and Various Reduction Factors, 2010-2070 (Average Earners)**



Source: Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, the 2000 Annual Report of the Board of Trustees of Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds 185 tbl.III.B5. \*The last three columns are based on the author's own calculations.



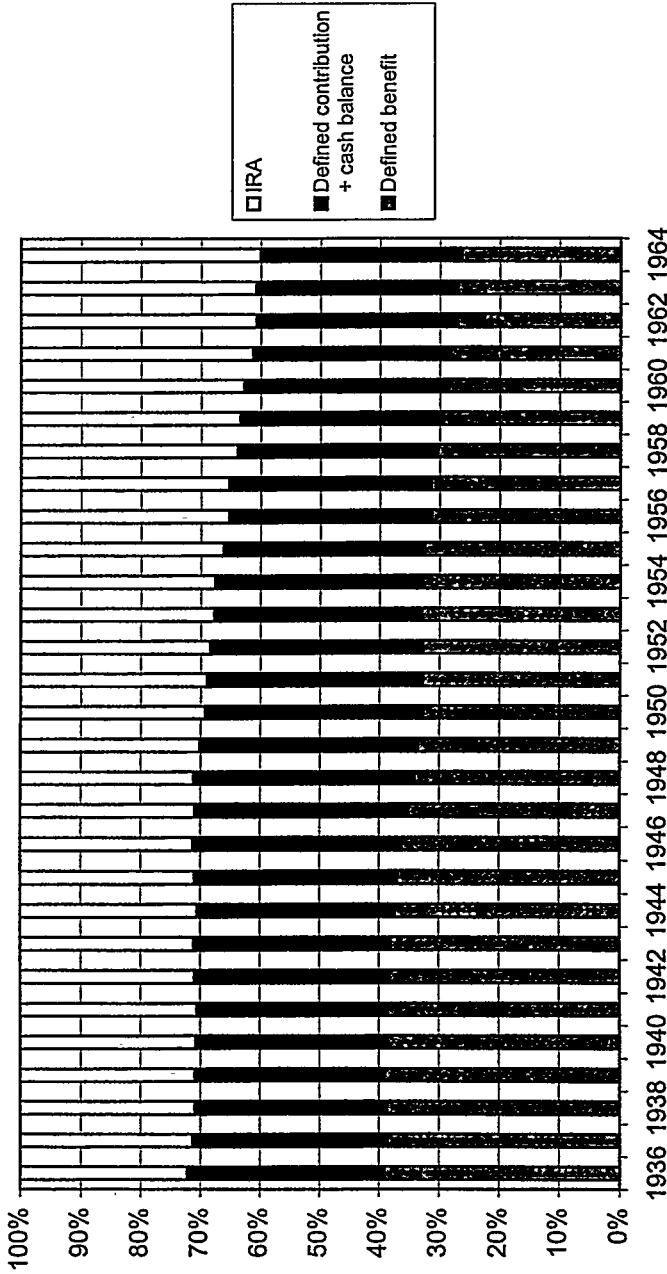
**Chart 6: Percent Reduction in Males Total Benefits, From Low to High Administrative Costs, by Birth Cohort, GB-KS Proposal**



Birth Cohort

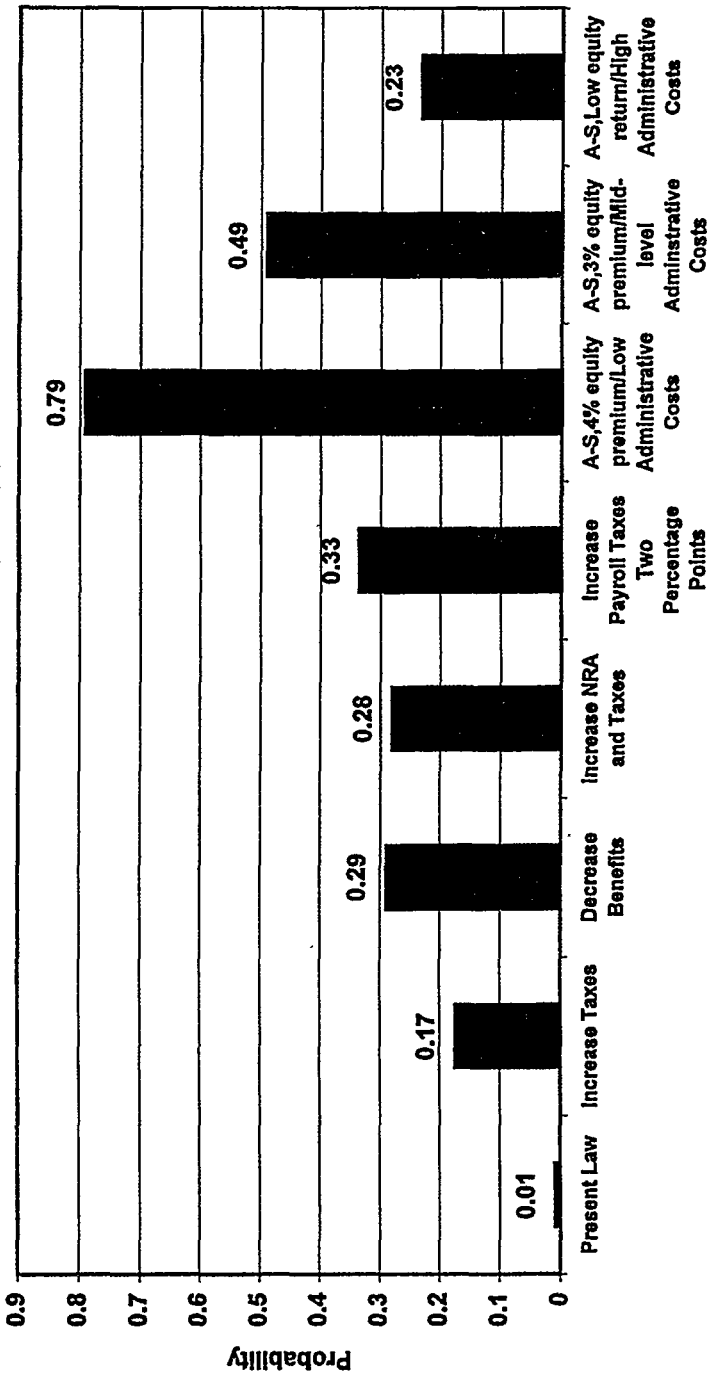
Source: Craig Copeland et al., *Social Security Reform: Evaluating Current Proposals*, EBRI Issue Brief (Employee Benefit Research Inst., Wash., D.C.), June 1999, at 10-11 (Gregg/Breaux-Kolbe/Stenholm Proposal introduced in 1998).

**Chart 7: Estimated Composition of Retirement Wealth for Males at Normal Retirement Age by Birth Cohort, 1936-64**



Source: Jack VanDerhei and Craig Copeland, *The Changing Face of Private Retirement Plans*, EBRI Issue Brief (Employee Benefit Research Institute, Wash., D.C.), Apr. 2001, at 14.

**Chart 8: Probability of Various Reform Possibilities Will Achieve Actuarial Balance**



**Reform Proposal**

Source: Craig Copeland, Social Security: Not All Reform Approaches Are Equal, EBRI Notes (Employee Benefit Research Inst., Wash., D.C.), May 2001, at 5.