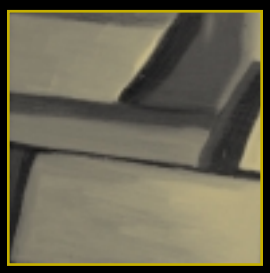
A Primer on Privatization

Joseph J. Cordes and C. Eugene Steuerle



THE RETIREMENT PROJECT

Occasional Paper Number 3

URBAN INSTITUTE

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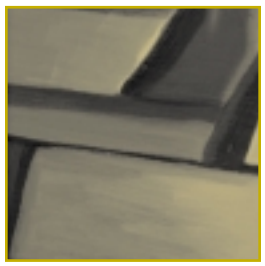

T H E R E T I R E M E N T P R O J E C T

Occasional Paper Number 3

The Retirement Project

ABOUT THE SERIES

THE RETIREMENT PROJECT IS A MULTIYEAR research effort that will address the challenges and opportunities facing private and public retirement policies in the twenty-first century. As the number of elderly Americans grows more rapidly, Urban Institute researchers will examine this population's needs. The project will assess how current retirement policies, demographic trends, and private-sector practices influence the well-being of older individuals, the economy, and government budgets. Analysis will focus on both the public and private sectors and will integrate income and health needs. Researchers will also evaluate the advantages and disadvantages of proposed policy options. Drawing on the Urban Institute's expertise in health and retirement policy, the project will provide objective, nonpartisan information for policymakers and the public as they face the challenges of an aging population. All Retirement Project publications can be found on the Urban Institute's Web site, http://www.urban.org. The project is made possible by a generous grant from the Andrew W. Mellon Foundation. This study was made possible by a generous grant from the J.M. Kaplan Foundation.

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ABOUT THE AUTHORS

JOSEPH J. CORDES, A VISITING FELLOW AT THE Urban Institute, served as associate dean for faculty affairs and programs in the Columbian College of Arts and Sciences at George Washington University from 1986 to 1989 and was chair of the department of economics from 1991 to 1997. He was a Brookings economic policy fellow in the United States Treasury Department's Office of the Assistant Secretary for Tax Policy from 1980 to 1981. From 1989 to 1991 he was deputy assistant director for tax analysis at the Congressional Budget Office. He is coeditor (with Robert D. Ebel and Jane G. Gravelle) of *The Encyclopedia of Taxation and Tax Policy* (Urban Institute Press, 1999) and (with Milton M. Carrow and Robert Paul Churchill) of *Democracy, Social Values, and Public Policy* (Greenwood-Praeger, 1998). He has published over 50 articles on tax policy, government regulation, government spending, and nonprofit organizations.

C. Eugene Steuerle is a senior fellow at the Urban Institute and author of a weekly column, "Economic Perspective," for *Tax Notes* magazine. He has worked under four different U.S. presidents on a wide variety of social security, budget, tax, health, and other major reforms, including service both as the deputy assistant secretary of the Treasury for tax analysis (1987-89) and as the original organizer and economic coordinator of the Treasury's 1984–86 tax reform effort. He is the author or coauthor of over 150 books, articles, reports, and testimonies, including the recent Urban Institute Press books *The Government We Deserve: Responsive Democracy and Changing Expectations, Retooling Social Security for the 21st Century, The New World Fiscal Order, Serving Children with Disabilities,* and *The Tax Decade.*

A Primer on Privatization

INTRODUCTION

JUST A FEW YEARS AFTER THE FIRST BABY boomers change from taxpayers into retirees, Social Security will begin paying out more in benefits than it collects in revenues. For the next three decades, working Americans are expected to come up with the income taxes necessary to pay interest and principal on bonds held by the Social Security trust fund, thus technically enabling it to run deficits for a while. By about 2040, however, those deficits will have led to the exhaustion of the trust fund, most baby boomers will have retired, and Social Security taxes will be sufficient to cover only about two-thirds of the benefits promised under current formulas.

Health programs for the elderly face the same demographic pressures as Social Security, plus rising health care costs. Because these programs rely heavily on general revenues as well as Social Security taxes, they are reducing the share of government revenues available for other important programs. The United States is not alone. Most developed countries are even further along in the process of devoting more and more government revenues to consumption by the elderly and near-elderly.

Almost everyone agrees that the current situation is untenable and unsustainable, but they hold different views on what to do about it. Maintaining promised benefits entirely by means of fiscal adjustments would require either raising payroll taxes or relying even more upon general revenues to pay for Social Security benefits; however, higher tax rates could further reduce the already dwindling support for programs benefiting the young and middle-aged. The growth rate of future benefits could be scaled back to match expected tax revenues, but this alternative raises the important issues of how to provide for the retirement income security of Americans and how large the basic benefits and the cutbacks in benefit growth should be.

Neither of these alternatives is as attractive as continuing with a system whose benefits consistently exceed its revenues—without requiring anyone to make up the shortfall. Such a system is not feasible, yet proposals for Social Security reform often seem to be judged against this unrealistic benchmark. Moreover, the gains and losses that would result from changing the system are calculated from a baseline that implicitly assumes a future of high benefits and low taxes. Faced with such unrealistic standards, it is hardly surprising that policymakers are wary of embracing proposals for reform that inevitably dash the public's hope that somehow the system can be brought into balance relatively painlessly.

The search for a palatable cure for what ails Social Security has revived an old debate about the fundamental character of the system. Should it be a pay-as-you-go system, where taxes are paid out almost immediately as benefits, or should it involve real saving? Several proposals have been put forward to privatize Social Security or to put additional saving into the existing Social Security trust fund. Such proposals confront an unavoidable fiscal reality, however: The money needed to generate this additional saving is over and above that needed to avoid the very large Social Security deficits projected in the future.[1] If the additional saving is undertaken early, it might generate additional returns to help meet future deficits. Still, creating a permanent surplus generally requires larger and earlier adjustments than simply bringing the system back into a permanent state of balance.

Proposals for privatization differ from each other in important specifics, but all share several common features. Individuals would be required to save for retirement. At least a portion of this government-mandated saving could be invested in private securities. Ownership of assets would be ascribed almost immediately to individuals, and they would exercise some control over their assets. Finally, most proposals would retain a significant pay-as-you-go Social Security transfer program as well.

Closely related to the concept of privatization are proposals to increase funding and saving *within* Social Security. Many of these proposals would also have the Social Security system invest a fixed portion in private securities. Some, like a recent proposal put forward by President Clinton, are intended to shore up Social Security with non–Social Security taxes that could have been used to fund other government spending or returned to taxpayers through tax cuts. These plans could even allow for individual accounts that receive the average rate of return from a pooled investment within the public system.

This primer attempts to clarify the principal issues surrounding privatization of Social Security and related proposals to fund Social Security and to dispel some misconceptions that have arisen in the debate about whether to privatize. In particular, it evaluates proposals to reform

Social Security on the basis of whether they achieve fiscal balance, protect the truly old and poor, and avoid saddling the government with any large contingent liability that would unfairly burden future workers.

A NEW PILLAR FOR THE CURRENT RETIREMENT SYSTEM

Basically, retirement in the United States rests on two pillars: a public system, in which mandatory contributions from workers are transferred to retirees, and a private system, in which voluntary contributions to pension plans are accumulated in private accounts and used to finance retirement.

The public system has three basic components. One is a welfare-like minimum benefit provided through Supplemental Security Income and Medicaid payments to the elderly, primarily for long-term care. These payments are not defined as part of Social Security or Medicare because they are covered by income taxes and other general revenues rather than by Social Security taxes. In addition, these benefits phase out as income increases and are available only to the poor, the near-poor, and those whose large medical expenses would otherwise impoverish them.

The second element is essentially a flat benefit. Workers who retire at age 65 receive 90 percent of the first few thousand dollars of average annual earnings on which Social Security taxes are paid. Thus, retirees with a very low average annual income—less than that earned by a full-time minimum-wage worker—have a high ratio of benefits to earnings. Medicare also provides an essentially flat benefit to low- and high-income individuals. These flat or almost flat benefits are distinguished from welfare by not phasing out as annual income from other sources increases.

The third component is a benefit that provides between 32 percent and 15 percent of taxable earnings in excess of the minimum noted above. In effect, there is a declining and fairly low ratio of annual retirement benefits to average annual earnings above the minimum. This "progressivity" is achieved through a rate schedule that provides additional benefits as average lifetime earnings increase, but at a rapidly declining rate for each additional dollar of earnings.[2]

The private pension system rests on voluntary contributions to funds or to accounts held by employees or by employers on behalf of employees. Unlike the public system, private pensions link the size of the retirement benefit more directly to the accumulations in these funds or accounts. Because of their voluntary nature, moreover, the amounts of deposits and accumulations vary widely. When private employers contribute to a plan whose defined benefits are based upon both past and future employment with the firm, individual ownership of each dollar of assets is harder to ascribe than when money is deposited directly into accounts (as in the case of so-called 401(k) plans). Either way, the money remains in the private sector. Moreover, under federal law, most plans are supposed to put aside enough funds to pay for all promised benefits even if the employer should go out of existence immediately—that is, most plans are required to be fully funded. (This was not always the case in the United States, and many European private plans are still significantly underfunded; in these plans, benefits are paid partly or wholly out of contributions by current employees or employers.)

Although this characterization of the two pillars on which retirement rests is rather abbreviated, it points to some fundamental differences that are particularly relevant to the debate about privatizing or funding Social Security. One is that the public system is largely unfunded, in contrast to the private system. This means that benefits are financed not from income saved and invested by beneficiaries when they were working, but instead by taxes collected from younger workers.

Another difference is that the private system has traditionally involved little redistribution of benefits. (A minor exception is when annuitizing retirement income causes those who live shorter lives to receive fewer benefit payments than those who live longer.) In contrast, Social Security redistributes income within and across generations. As described above, the amount of Social Security income received is not proportional to Social Security taxes paid during a lifetime, and benefits received by retirees are paid by taxes collected from workers. (The fact that recently a small percentage of these revenues has been saved in a "trust fund" does not fundamentally alter this fact.)

Proposals to reform Social Security by adding mandatory saving—either in private accounts or within Social Security—would add a third pillar to the retirement system. In this context, *publicly mandated retirement saving is really a hybrid between a public retirement system with a mandate (tax) but no saving and a private system with saving but no mandate*.

If the existing public and private systems were not changed at all, it would be hard to argue that publicly mandated saving would reduce retirement support. The debate arises, therefore, when the new hybrid is offered as a partial or complete replacement for an existing system. Some, for instance, would remove most of the public system and replace it with mandated saving. Others fault the private retirement system for inadequately covering the population and would replace much of it with something

close to mandated saving. Thus, attitudes toward this third pillar often depend upon whether the new mandate adds onto existing taxes or subtracts from the revenues available to either of the other systems. Structurally speaking, however, it seems almost illogical to argue that mandates without saving and saving without mandates are both acceptable, but mandated saving is not.

WHAT REFORMING SOCIAL SECURITY CAN AND CANNOT ACCOMPLISH

The catalyst for Social Security reform is not the debate over mandatory saving, which is not new, but rather the fact that the current pay-as-you-go system cannot be sustained. To explain why this is so, it is necessary to describe briefly how the system works and why it will encounter difficulties in the next century. It is also important to explain why it can be misleading to frame the debate about Social Security reform in terms of improving the "rate of return" to the retirement system as a whole.

How a Pay-As-You-Go System Works

The essence of the public pay-as-you-go system is that taxpayers contribute to their parents and other retirees of that generation and then claim an entitlement to later transfers from their own children and other members of the next generation. The mechanics of how such a system works are illustrated in the accompanying box.

The promised transfers are unfunded because they are backed not by any assets that have been set aside to pay for them, but rather by a political promise that each successive generation will pay taxes to provide retirement benefits to each previous generation. As long as successive generations are in a position to pay more taxes per recipient than previous generations were, it may appear that there is a positive "rate of return" to this evolving set of transfers. The first generation to receive retirement benefits—generation 0 in the example—contributes nothing (in practice, almost nothing) to the system but gets a net transfer. The next generation—generation 1—pays for the initial transfer but then claims a larger obligation from the next generation, and so on.

This process of rolling transfers masks the fact that for every transferee who benefits, there must be a transferor who pays the costs. Thus, generation 1 must forgo real or potential consumption to pay for the transfer of $1,000 to generation 0, which is likely to consume most of the transfer. This may appear from generation 1's standpoint to be offset by the promised transfer from generation 2, and so forth.

Interestingly, almost all promises of entitlements and obligations made to future beneficiaries and taxpayers

PAY-AS-YOU-GO FUNDING OF RETIREMENT BENEFITS

A simplified illustration of how a pay-as-you-go Social Security system works is shown below. The example assumes that the Social Security system is set up in year 1, with the following simple benefit structure:

- Retirees alive in year 1, denoted as generation 0, receive a retirement benefit of $1,000 that is financed by $1,000 in payroll taxes collected from those working in year 1, known as generation 1.
- Generation 1 is assumed to retire in year 2 and receives a promised benefit of $1,100 that is financed by $1,100 in payroll taxes collected from those working in year 2, or generation 2.
- Generation 2 retires in year 3 and receives a promised benefit of $1,210 that is financed by $1,210 in payroll taxes collected from those working in year 3, or generation 3.
- Generation 3 retires in year 4 and receives a promised benefit of $\$T_4$, which equals the amount of payroll taxes, $\$T_4$, collected from generation 4, and so on.

Year	Generation 0		Generation 1		Generation 2		Generation 3		Generation 4	
	Tax	Benefit	Tax	Benefit	Tax	Benefit	Tax	Benefit	Tax	Benefit
0	$0									
1		$1,000	$1,000							
2				$1,100	$1,100					
3						$1,210	$1,210			
4								$\$T_4$	$\$T_4$	

alike have been made by politicians who have long since passed from the scene. Despite the fact that Social Security sets growth rates for decades and centuries to come, there is really no way that any set of policymakers can know what rate of growth to ascribe to future beneficiaries because they don't know the future status of the economy or the number of workers available to pay the taxes. That there is now a shortfall, therefore, is not surprising.

The "return" that participants perceive from contributing to the transfer system differs in an important way from the return earned on private saving, which is backed by actual assets. Because transfers are immediately paid and received, there is really no underlying asset to back promised benefits in a pay-as-you-go transfer system. Thus the notion of earning a return on contributions in such a system is misleading. Social Security may be seen as different from other transfer programs, such as welfare, because it is financed by payroll taxes that are earmarked expressly for retirement benefits. People believe that taxes paid today support a system that will provide them with retirement income in the future and in this sense believe that they earn a return on their payroll tax contributions. But financing transfers with earmarked taxes does not change the underlying economics of an unfunded transfer system.

Why the Current Pay-As-You-Go System Will Run into Difficulty

Although most proposals for reforming Social Security stress the desirability of boosting private or public saving, or both, the problem that looms for virtually every social insurance system in the industrialized world is that the ability of workers to make transfers to increasing numbers of retirees is on the wane. The benefit growth promised currently is simply not sustainable, given existing mortality and fertility rates.

For the first 50 years of Social Security, retirees as a whole got back significantly more than they paid in. This situation developed because the benefit formula was based not upon past contributions but upon past earnings subject to tax and because later generations were taxed at higher and higher rates. A more fully funded system would have required earlier generations of retirees to pay considerably more for their own benefits.

Consider the system at startup in 1940, when benefits were paid out to individuals who had contributed almost nothing. Coming in the aftermath of the Depression, Social Security's goal was to provide some minimum level of retirement benefit. As such, it is not surprising that the two elements of redistribution could be combined: (1) that workers could make transfer payments to retirees and (2) that retirees with lower lifetime earnings would receive a higher benefit or replacement rate relative to those earnings. Note, however, that the first windfalls were provided not simply to the first generation of retirees, but to almost all retirees, rich and poor alike, for close to half a century. This is analogous to enacting one system when generation 0 approaches retirement, an add-on system when generation 1 approaches retirement, and yet another system a generation later. In practice, tax rates for Social Security and Medicare together were raised approximately 3 percentage points each decade, starting at 3 percent of taxable earnings in 1940 and rising to 15.3 percent by 1990. The 1990s represent the first decade in which tax rates under the old-age programs have not been raised.

Recent demographic trends have been at work to shrink the number of taxpayers per recipient. Although this is normally thought of as a baby boom problem, it reflects the combined effects of several factors. Increasing longevity and earlier retirement have resulted in an extraordinary increase in the number of years Social Security must pay out benefits to retirees. Declining fertility and earlier retirement reduce the number of workers available to make transfers. Once the first cohorts in the baby boom generation begin to retire, about 2008, the effects of these two trends will begin to be felt with force in the pay-as-you-go system. The combination will cause a decline in the number of workers per beneficiary (or a rise in the so-called dependency ratio) from over three in the 1990s to fewer than two after the year 2030.

Why Reform Cannot Change the *Aggregate* Rate of Return

To restore balance, some future generations of retirees must inevitably receive less in benefits or pay more taxes than they otherwise would. This has sparked proposals to replace all or part of the current pay-as-you-go system with a system of publicly mandated retirement savings designed to increase the return to participants in the Social Security system. This notion can be misleading, however.

In a pay-as-you-go system, every dollar paid out in taxes is immediately matched by a benefit payment on the other side of the ledger. The system as a whole, therefore, does not earn a rate of return in the financial sense because no funds are set aside to grow over time. What is crucial to understand is that changes to a pay-as-you-go system face exactly the same constraint. *No one can change the net rate of return for everyone because as soon as a transferor pays a dollar less (perhaps because the dollar is going to be contributed to a mandatory private system), some transferee receives a dollar less.*

To be sure, participants in a pay-as-you-go system may receive transfers when they retire that exceed transfers made while they were working. Moreover, the ratio of

the financial value of transfers received to transfers made is often described as the return that individuals receive from participating in the transfer system. However, this return ultimately depends on a *politically determined* formula that reflects not only the willingness but also the ability of each successive generation to finance the retirement benefits of their elders. The political promises to each generation may be based upon the transfers they made to the previous generation, but they could just as well be based on the state of the economy at the time of their retirement. The real question is whether the rate of growth in transfers needed to generate a "positive return" is sustainable or desirable. In times of significant wage growth and high birthrates, the rate of growth of political promises can be kept high without resorting to increased tax rates on successive generations.[3]

Conversely, with little growth in the number of taxpayers and modest growth in wages, the politically determined rate of return will be quite low for the same tax rate.[4] One can appear to dodge this constraint for a while by raising tax rates, but tax rates can only rise so far before there is a day of reckoning. In practice, the reckoning is likely to occur well before payroll tax rates reach 100 percent because very high payroll tax rates become both economically costly and politically infeasible.

Even if the government substitutes a funded system with saving for an unfunded pay-as-you-go system, it generally can't change the rate of return earned on such saving.[5] It can require that citizens save in public or private funds, but such a mandate does not by itself increase the rate of return to capital or to the saving that individuals might have undertaken independently of the government.

None of this implies that a larger or smaller transfer system or a system funded by saving is good or bad. There may be social gains from providing for the well-being of the old through transfers of income between generations or economic benefits from increasing saving. More transfers to some particular groups of individuals may be considered fair, even though their gains are matched by an equal and opposite loss for other groups. And a redesigned system may remove other distortions in the economy, such as the discouragement of work, especially by secondary workers in a family. These are among the many legitimate issues to consider in weighing how much to rely on a transfer or a funded system in the future. But there are no magical increases in rates of return from either changing the amount of transfers made in the economy or mandating that people invest in assets that already offer them a similar rate of return.

What, then, is being argued by those who suggest that rates of return can be increased by switching from pay-as-you-go systems to funded systems? They are comparing the rate of return on investment, which presumably does not fall too dramatically with new investment, with the politically determined rate, which has fallen with the decline in workers relative to beneficiaries. The rate of return on investment now appears higher, so they conclude that replacing the old system will increase the rate of return to society as a whole. The problem, however, is not in comparing returns to future generations, but in valuing the transfer to all generations, including those who are currently retired.

Think of the transaction in these terms. You give a dollar today to someone who is retired and receive a relatively unattractive, politically determined rate of return on that dollar, say 50 cents in present-value terms. You could have bought your own future benefits in the private market for 50 cents rather than shelling out a dollar. But the transferee got a dollar. Therefore your gain of 50 cents from switching instantaneously to a private retirement system is offset by the transferee's loss of a dollar. It would be hard to argue that the "aggregate" rate of return in society had been changed. In fact, if you got back absolutely nothing—as is the case in most transfers made through government—you still could not claim that society as a whole would be better off if you had reduced your transfer to the transferee.

Another way of saying this is that one can't change the rate of return in either a pay-as-you-go system that has no rate of return or in a mandated saving system that does not pretend to raise rates of return relative to other, private investment. Mixing and matching the two systems does not change the basic nature of either one. An analogy might be made to adding oil to vinegar. No matter how much oil is added, the acidity of the vinegar doesn't change. Shaking both substances in a bottle doesn't change the acidity of the vinegar either, though it will affect one's perceptions (or political expectations, in the case of Social Security).

One can change the ratio of oil and vinegar in the mixture (for instance, there can be reductions in future promises of transfers to be made) and then calculate the total amount of acid relative to the total quantity of liquid. Still, the acidity of the vinegar does not change, nor does the acidity of the oil.

To summarize: (1) in a pure pay-as-you-go transfer system, government policies cannot change the "aggregate" rate of return because there is nothing on which to generate a return (one more dollar returned to a current transferor means one less dollar paid to a current transferee) and (2) a mandate to save cannot increase the rate of return available to private savers. The politically determined return received by particular generations in a transfer system can be changed, but only by raising or lowering the burdens on other generations. Similarly,

mandatory saving can improve retirement income security, but only to the extent that the mandate succeeds in increasing private saving, which requires individuals to postpone current consumption.

A further source of confusion in the current debate is that the public system has very recently added a temporary, modest amount of saving. In this sense, it is not a *pure* pay-as-you-go system. Whatever funding exists, however, does not change the return on the pure transfer portion, nor does it raise the rates of return on saving. This issue can be taken to yet another level. Suppose one believes that a higher return could be earned by investing trust fund surpluses in equities as well as in government bonds. Whatever the fiscal merits of changing the trust fund portfolio in this way, the failure of the government to hold equities simply means that claims to income from equities are held elsewhere in the economy. Since shifting trust fund investments from bonds to stocks or making other portfolio adjustments does not increase the overall amount of income from capital in the economy, the government's gain in income, if any, from a portfolio shift is matched by an equal and opposite reduction in equity income in some private accounts. The shift in assets held by the government may or may not be desirable from a policy standpoint, but changing the mix of publicly held assets doesn't by itself change the aggregate rate of return in the economy. Moreover, simply creating a "surplus" in the Social Security trust fund does nothing to raise overall saving in the economy if that surplus makes it possible to run a deficit of equal size elsewhere in the government budget.

SHORING UP THE PUBLIC SYSTEM: WHAT SHOULD IT ACCOMPLISH?

The combination of demographic shifts, lack of funding in the pay-as-you-go system, and a more general desire to increase saving has brought two major issues to the fore: (1) making the public system itself solvent and (2) increasing the amount of funding or saving set aside for retirement. To put proposals for privatizing Social Security into proper perspective, these issues must be separated.

Making the System Solvent

The imbalance between Social Security benefits and taxes means inevitably that adjustments must be made in one or the other, or both. Promised benefits can be scaled back in a variety of ways—by increasing the retirement age to reflect past and future increases in life expectancy; by reducing the growth rate in annual benefit payments, especially for higher earners; and so forth. New revenues can be found through higher tax rates or an expanded base that would tax more of the earnings of very high earners (although under the present system, this would also provide them with higher benefits), or by diverting fiscal resources from other uses, such as other programs or tax reductions (implicit in proposals for using projected federal budget surpluses to shore up Social Security and Medicare).

There is no way to avoid the requirement to match revenues and payments in a Social Security system. As a political matter, one can attempt to mask the source of additional revenues or of expenditure reductions, but the need to make such adjustments cannot be avoided. One can also seek to shift some of the fiscal pain of adjustment from one generation to another. Replacing the existing transfer system with a fully privatized system would merely eliminate the taxes and benefits that would otherwise be paid under a pay-as-you-go system. In the process, some parties would gain more benefits than they would lose from the abolition of the pay-as-you-go system, but the opposite would be true for others.

Despite the way these issues are played out in the press, serious proposals for privatization usually do try to match promised benefits with revenues. Although specific proposals may disguise the changes that will take place in the public system by discussing what is happening to private accounts, the public pillar is still being stabilized—albeit at a different scale of promised benefits or taxes—even while a new pillar is being added.

Beyond Solvency

Although solvency in the current system can be "readily," if not painlessly, attained through benefit and tax adjustments, many observers think it is not sufficient to simply shore up what would still be an unfunded transfer program. Each generation's benefits would still depend on the ability and willingness of subsequent generations to make transfers. Moreover, it is extremely hard to determine future mortality and fertility rates with any degree of precision, so there is really no way to know in advance whether the promised growth in benefits is sustainable or reasonable. (One could index for mortality and fertility, but this would add some modest uncertainty to future beneficiaries from the benefit formula rather than focusing on taxpayers or on how the political process reacts to imbalances over time.) Almost no matter how one slices it, at a constant tax rate and under current demographic and economic trends, the sustainable politically determined return falls to an average of around 2 percent in real terms for future contributions to the system as a whole—less than that for some workers, more for others.[6]

Some proposals would make further use of revenues from non–Social Security taxes to shore up Social Security (as well as Medicare). Changing the source of

revenues does not really alter the fundamental dynamics of the transfer system; generally speaking, the taxpayer still pays, whether in income taxes or Social Security taxes. Proposals have also been made to structure general revenue financing of future benefits in a way that would cut non–Social Security expenditures. In that case, those who pay initially are those who would have received the benefits of these other programs.

For many, the mandated public pillar should be made to look more like the voluntary private pillar by introducing to the former some elements of advance funding. Then at least a portion of future retirement benefits promised to each working generation would be backed by funds that had been set aside and then invested in financial assets. The accumulated interest and principal on these assets would provide retirement benefits, thereby reducing the reliance on transfers and taxes from future generations. Ideally, the deposited funds would also lead to net increases in government and private saving, thus helping to foster economic growth through increased capital formation and higher productivity.

Advance funding demands a new source of revenues. It requires an increase in the amount of income that each working generation is required to save in order to help support its own promised benefits. This broad objective can be accomplished in two different ways.[7]

- Benefits can be funded by creating and maintaining a surplus in the current Social Security trust fund that is not offset by a deficit in the rest of the government budget; this surplus, in turn, can be invested either in government securities, as is the current practice, or in a diversified portfolio of private securities and government bonds.
- Alternatively, benefits can be funded by channeling a portion of mandated contributions into private accounts, which could then be invested in government bonds, equities, or both.

The notions of advance funding, investing in equities, and privatization of Social Security have frequently been linked in the public debate, but these three concepts are distinct. Achieving advance funding does not depend on privatization, nor is investing in equities necessarily a component of any advance funding system. When proponents of some amount of privatization began to advocate the merits of increasing saving for retirement, supporters of the current system countered that the same amount of saving could be accomplished by building up and maintaining surpluses in the Social Security trust fund. When advocates of privatization next argued that stock market rates of return offered large gains for future retirees, supporters of the current system concluded that comparable gains could be obtained by investing an equivalent amount of trust funds in the stock market. This political dynamic serves to reinforce the point that advance funding, investment in the stock market, and privatization need to be considered as separate issues.

THE TRANSITION DILEMMA

Replacing all or part of the current pay-as-you-go system requires that resources be earmarked to finance the transition to a funded system. Thus, whether advance funding is undertaken through a government trust fund or through private accounts, some initial generation(s) of workers must bear the cost of improving the financial value of Social Security for future generations. Suppose it was decided to fund 100 percent of the benefit promised to today's workers without reducing any benefits paid to current retirees. In that case, the current working generation would need to pay sufficient taxes to fund its own retirement benefits as well as financing the retirement of previous generations. It would be as though generation 3 were required to fund its own retirement in advance without cutting generation 2's benefits. Generation 3 would still have to pay a tax of $1,210 to generation 2, as well as save enough to fund its own benefit—$\$T_4$ in the example. Moving toward partial rather than 100 percent advance funding would modify this example in degree but not in kind.

Although one might object that financing the move from an unfunded to a funded system is unfair to the transition generation, economic growth generally means that each generation is better off than previous ones. It should be noted that when much of the private pension system went from being unfunded to funded, some generation of workers had to pay twice.[8] Interestingly, there was almost no outcry, in part because the cost of the transition was viewed over time as providing greater protection to all workers in individual firms.

The transition dilemma is likely to be particularly acute in the current setting. Consider a simplified Social Security system that covers all wages of all workers. At four workers per beneficiary, a 10 percent tax rate is sufficient to provide beneficiaries with a replacement wage that, on average, is equivalent to about 40 percent of the before-tax earnings of the workers. At three workers per beneficiary, either the replacement wage falls to 30 percent with a 10 percent tax rate or the tax rate must rise to just over 13 percent to keep replacement wages as high as before. Three workers per beneficiary is less than the current ratio. At two workers per beneficiary—approximately the ratio projected for 30 years from now, either the replacement rate falls to 20 percent with a 10 percent tax rate, or the tax rate must rise to 20 percent to keep replacement rates the same.

This very simple arithmetic illustrates the challenge facing a system that promises generous benefits to a large proportion of the population for approximately one-third of their adult lives. Simply to maintain transfers under the pay-as-you-go part of the system, tax rates must rise, replacement rates must fall, or people must work longer to keep the ratio of workers to beneficiaries higher. The simple fact is that at a ratio of two workers per beneficiary, a 10 percent rate does not go very far toward paying for a minimum level of benefits.

This situation poses a problem for attempts to privatize. In the 1994–1996 Social Security Advisory Council, one group that strongly favored privatization insisted that to make it meaningful, approximately one-half of the current old-age and survivors' insurance tax rate (5 percentage points out of the 10.4 percent rate) should be put into private accounts. This proposal created several problems. The financial resources required to fund the private accounts and maintain promised benefits to retirees were estimated at a peak to increase direct federal borrowing from the public by about $2 trillion. Therefore, a new tax was proposed to cover some of the revenue shortfall caused by shifting payroll taxes into private accounts. The new tax was essentially aimed at eliminating the new direct liabilities over 75 years. Even then, the minimum benefit out of the pay-as-you-go part of the system was only about two-thirds of today's poverty level.

This particular privatization scheme—one of the few that tried to meet all balance sheet requirements and was formally estimated by the Social Security actuaries—essentially would create a two-tier system, with one tier providing a minimum benefit financed on a pay-as-you-go basis and the other paying benefits from accumulations in private accounts. The inescapable arithmetic that needed to be confronted in developing the proposal was that a 5.4 percent tax rate does not go very far in providing a base of protection if only two workers are paying for every beneficiary. Even a 10.4 percent tax rate doesn't go very far, and if all of that is used to finance benefits in the pay-as-you-go system, there will be no money left over to set up new government-mandated private accounts.

Privatization faces a fundamental problem when it tries to generate funds from an already overpromised system. Encouraging private saving, even mandating it, may be a useful addition to federal policymaking, but it must be accomplished in a way that ensures that if the market fails or individuals fail to save adequately, the backup system does not have a huge contingent liability. When the benefit provided in the basic tier of the Social Security system is small—as it is in the plan described above—the contingent liability of the government to make good on implicit promises in the privatized tier in the event of a market downturn could be quite large.[9] If, instead, the basic benefit is intended to be quite adequate, even in a market downturn, then the government's contingent liability will be small or even zero, but there will be fewer financial resources left over to set up mandated private accounts.

One plan put forward by the National Commission on Retirement Policy set up a minimum benefit that left low-income individuals even better off than they are under current law. Therefore, whatever happened to their individual accounts, that money was simply a bonus on top of an improved base benefit. By the same token, this higher basic benefit meant that there were many fewer dollars to take out of the existing Social Security tax rate, so it left less that could be effectively converted from a pared-down Social Security system into a mandate. Another group within the Social Security Advisory Council dealt with this dilemma differently. It gave up on trying to carve out part of the existing Social Security tax and essentially added a small individual account by requiring a mandate over and above the existing rate. Thus, the 10.4 percent Social Security tax was left to cover a base benefit, and the additional pillar was created through an add-on mandate.

FUNDING THROUGH PRIVATE INDIVIDUAL ACCOUNTS VERSUS THE SOCIAL SECURITY TRUST FUND

After addressing the issues raised by moving from an unfunded to a funded system, the next step is to examine the differences between achieving advance funding by increasing saving within the Social Security trust fund versus increasing saving through mandated individual accounts. Much of the debate over these alternatives has centered on the following:

- The extent of redistribution that can be accomplished within each system;
- Whether investments can be made in equity rather than simply government bonds;
- Who should bear the risk for any equity investment;
- The extent to which government would try to control the direction of equity investment;
- Whether national saving would actually go up;
- How reform would affect other incentives and distortions; and
- Additional administrative costs inherent in funded systems.

Before addressing these topics, it is worth noting that some of them arise simply because money would be saved and future promises of retirement benefits would be

backed by real assets. These assets represent claims to future returns that are almost always uncertain in one respect or another. Real assets, therefore, cannot help but raise questions of ownership and control and of risk, regardless of whether the assets are privately or publicly held. That is hardly a reason to oppose funding, however. Pay-as-you-go systems have no real assets, only promises to tax future citizens to match some unfunded benefit promises from the past. They contain their own types of risks—that the promises can't be met or that the lack of funding leads to a decrease in saving and growth in society. Opposing funding because it entails different risks from a pay-as-you-go system is like choosing to drive instead of fly because there is a risk that the plane may crash.

Redistributional Policy

An important feature of achieving advance funding by building up a sizable balance in the Social Security trust fund is that the benefits would still be paid from the trust fund and not from personal accounts. If such advance funding were the only addition to the existing system, then the distribution of benefits among the elderly would be the same. This is seen as an advantage by those who value the *benefit* side of the Social Security system more or less as it is. They put a heavy weight on the redistribution attempted by the current system; their fear is that this redistribution—especially given the low non–Social Security income of the majority of the elderly—would be lost.

Unfortunately, the issue of redistribution is not often considered comprehensively. There is much redistribution (not just benefits, but benefits over and above taxes paid) within Social Security to the rich as well as the poor (Steuerle and Bakija 1994). By the same token, many elderly persons still live in poverty even though Social Security pays out far more benefits than would be required to maintain all of the elderly above poverty thresholds. In response to these conditions, a plan put forward by the National Commission on Retirement Policy proposed increasing retirement ages and bringing expenditures more into line with revenues, while removing many more of the elderly from poverty and substantially increasing the basic monthly entitlement that workers with low earnings, especially women, would receive.

Despite their concern over redistribution, many proponents of the current system are wary of improving basic benefits for lower-income individuals. Although this may at first appear to be contradictory, the issue is primarily one of political perception. For the same amount of total spending, boosting these basic benefits would reduce the relative benefits for those with higher incomes. Effectively, higher-income individuals would receive a lower marginal return for their additional taxes. This might reduce political support for the system among the well-off. At the same time, if some people received a market rate of return on private accounts, whether mandated or voluntary, they might become disenchanted by the comparison between the return on the private account and the return on the contributions needed to maintain the basic Social Security benefit. As a consequence, they might not want to pay the taxes necessary to support already retired generations or lower-income individuals.

Whatever the merit of this argument, how people would react in the future cannot be gleaned from the past because the character of the system changes dramatically from one generation to the next. As noted, the Social Security system to date has provided mainly large windfalls to everyone, rich and poor alike.

The argument that the public system must be *larger* to sustain the same amount of redistribution to those in need implies the following type of calculation: that richer workers would prefer to pay more taxes on which they got back a politically sustainable rate of return of, say, 1.5 percent than fewer taxes on which they got back a politically sustainable rate of return of, say, 1.0 percent. Yet it is unclear why higher taxes earning less than a market rate of return would make individuals happier than lower taxes earning an even lower rate of return.

Some supporters of privatization believe it would be desirable to rid Social Security of most or all redistribution (thus seeming to validate the fears of those who view any system of individual accounts as the first step toward eliminating redistribution). For example, there would be no redistribution of income between highly paid and less well paid workers under a completely privatized scheme. Retirement benefits received by each participant would be directly proportional to their accumulated contributions and the return paid on those contributions.

Some amount of redistribution is an inevitable consequence of moving to any type of funded system. As explained earlier, switching from a pay-as-you-go system requires eliminating some transfers currently being made or raising additional taxes. Both actions create current losers to finance benefits enjoyed by future winners—otherwise there are simply no additional dollars available to put into private accounts. Perhaps the main issue that may be overlooked is that under a system in which all or part of future retirement income is financed from private accounts, the government would be left with a large contingent liability to cover the needs of those who failed to attain an adequate income, either because of falling

markets or because of individual losses due to poor or unlucky investment. The costs of the implicit insurance arising from this contingent liability are seldom calculated.

Still another redistributional issue is how gains from privatization would be shared among future generations. (For this purpose, we ignore potential losses to existing or near-term retirees.) Suppose that benefits and taxes are both cut back proportionately in a pay-as-you-go system (whether by 10 percent or 100 percent each) in order to finance some privatization. Because Social Security has a progressive benefit formula and a roughly proportionate tax formula, the hit would be proportionately larger for those with lower incomes. That is, the proceeds of Social Security contributions that are now shared in a way that benefits lower-income workers would instead be distributed proportionately to income. As a consequence, whatever the gains to future participants, future high-income workers would gain disproportionately.

It is possible to avoid such disproportionate effects in a Social Security system that is pared back without being wholly privatized. The trick is to increase the basic Social Security benefit for low-income workers while reducing the benefits for higher-income workers. This device would offset the disproportionate gains from partial privatization of individual accounts. In effect, because the existing system pays higher benefits to higher-income persons, and in some cases still provides them with windfalls, the following policy trade-off becomes possible: Flatten the core benefit structure in order to raise the basic Social Security benefits of low-income individuals; eliminate some of the windfalls currently enjoyed by higher-income individuals; and in exchange give individuals the opportunity to invest in individual accounts.[10]

Partial privatization could also be done in a way that would separate the welfare and individual equity components of the existing program. Such a separation would make the redistributive elements of the program more explicit and facilitate a reduction in poorly targeted transfers. A primary example of such transfers is spousal and survivor benefits, which penalize families with secondary workers and are structured to pay rich stay-at-home spouses with or without children more than poor stay-at-home spouses with children. Big losers in this part of the transfer system are single parents who both work and care for children.

Government Bonds versus Private Equities

Currently, any surplus in the Social Security trust fund is invested entirely in government bonds. This practice could be continued under a system that was entirely or partially advance funded, or a sizable portion of any trust fund balance could be invested in private equities.

The attraction of investing some or all of the surplus in equities seems clear at first. As the debate over privatization became more intense, those seeking to maintain the current system came to realize that they could claim roughly the same "rate of return" and the same amount of gross saving that supporters of privatization got simply by buying a similar amount of stocks with a similar amount of advance funding. Historically, investments in equities have paid an average annual return after inflation of 7 or 8 percent, whereas the comparable return on government bonds has been roughly 2 percent. This differential implies that investing a portion of the trust fund in equities might boost investment returns, which in turn would lessen the need to increase payroll taxes or cut benefits in order to build up a significant surplus.

There is no magic money from investing in the stock market. One issue is simply whether past experience necessarily reflects the future. At the end of the 1990s, for instance, the earnings-to-price ratio on stocks was for the first time no higher than the interest-to-price ratio on bonds. Even if a higher stock return continues, it reflects a return to risk. Stock returns have fluctuated considerably from year to year; over the past 70 years or so, stock returns were actually negative in nearly one out of every four years (GAO 1998). This raises the likelihood that at some points in the future, the value of the equities held in the trust fund would not be sufficient to fund promised benefits. Thus, the question of whether the trust fund surplus should be invested in equities boils down to a trade-off between risk and return. (The cost of removing this risk, by the way, would almost exactly equal the expected differential between an interest rate and a stock market return. That is, if the government invested in the stock market but then bought options that would effectively insulate it from the additional risk, then the cost of those options would reduce its stock return to about a bond return.)

Another issue is whether it makes sense for the government as a whole to engage in arbitrage—investing in the stock market while selling additional debt to the public in order to purchase those stock assets. If Social Security can invest in the stock market, why not the Forest Service with its fees or the trust funds for airports and airways, highways, and environmental purposes? If arbitrage makes money for the government, why should it stop with trust fund assets? Should the government borrow even more so that it can invest in domestic or foreign securities and make money out of the arbitrage? What if foreign governments start to play the same games?

There is also no additional return to the economy if the government simply changes the mix of assets held in

its portfolio. Whatever gain there might be to the government from selling more bonds and buying more stocks, there is an equal and opposite loss to those who now have to purchase more government bonds and own fewer stocks. The government may seek to capture the higher returns from holding equities by engaging in this type of portfolio behavior, but it is simply an alternative to taxing the public at a heavier rate to move returns from the private to the public sector.

Finally, it bears emphasizing that proposals to have the Social Security trust fund purchase stocks were often offered to counter the seemingly painless gains arising from the arbitrage implicit in proposals to shift to privatized accounts. In one of the plans put forward by the 1994–1996 Advisory Council, the government would need to borrow more to finance a transition, and during that transition individuals would be buying stock with a share of what is now their Social Security tax, while the government was borrowing more. This plan, too, seemed to generate some of its additional returns without any additional saving, but only through an arbitrage process that did not take into account who would bear the cost on the other side of the transaction.

Who Should Bear the Risk?

Whether to allow equity investment, either in the public trust fund or in individual accounts, is partly a question of risk taking and who should bear those risks.

One needs to be very careful in assessing the cost of assuming new risk. Some risks with very low probability (another war or a stock market that crashes and does not fully recover) have costs that are not reflected well by traditional summary statistical measures, such as expected return and variance on that return. One reason is that the effective costs of being in a poor economic state are often well in excess of the effective benefits of being in a good economic state. To take an exaggerated example, suppose the average income is $10,000 and there is only 1 chance in 1,000 of its being zero, 1 in 1,000 chances of its being $20,000, and 998 chances out of 1,000 of its remaining $10,000. It is possible that the zero event might entail starvation or other quite severe outcomes. Statements that there is only a slim chance of a bad outcome are not fully informative unless they take into account the consequences of that bad outcome. Individual investors may instinctively realize this aspect of risky investments to the extent that they do not view a small probability of receiving a very large gain as sufficient compensation for taking a chance of suffering an equally large loss with an equally small probability.

One distinctive feature of equity investing through the trust fund is that the risks of stock market investing would be borne almost entirely by workers, assuming a promised level of benefits were to be maintained.[11] Of course, if equity investments performed as well as or better than expected, some groups of workers might eventually benefit from some of the rewards in the form of lower payroll taxes. Alternatively, as has occurred often in the case of defined benefit pension plans, there may be political opposition to returning any excess amounts to anyone other than the beneficiaries. Workers could then bear the downside risk in poor markets, while losing any upside gains in good markets.

Should workers as a group bear the risk from a downturn in the market? One method of considering this issue is to ask who can best bear the risk. If retirees would be substantially dependent upon stock returns to maintain a minimum standard of living in retirement, then perhaps workers should bear the additional risk, just as they bear much of the cost of trying to ensure a minimum standard of well-being for the elderly through the existing Social Security system. In this case, workers have the greater command over society's resources, and they can be called upon more easily to back up the system.

On the other hand, if some degree of well-being is already guaranteed for the retired—perhaps because a core Social Security system provides an adequate minimum benefit—then it is far less clear that the nonelderly should bear most of the risk. Today, many of those on Social Security at all ages report being in good health and are better off than many nonelderly taxpayers, whether measured by assets or income. Retirees in their 60s and early 70s normally have life expectancies of 15 years or more. Does it make sense for many who are less well off to bear the risks of many who are more well off, at least in terms of current consumption opportunities?

Imagine a situation like that in 1929, where a stock market crash took place simultaneously with a large increase in unemployment. The needs of workers and of the unemployed might easily exceed those of retirees on Social Security—especially if the Social Security system continued to encourage people to retire for the last third of their adult lives. The resources needed to back up programs for the elderly in this type of downturn would reduce private and public resources available to other groups in the population. Although it is often forgotten, the Social Security Act was originally concerned with the well-being of all Americans, not just those who were retired (Steuerle and Bakija 1994).

If there are risks inherent in a public system with stock market investment, there are also risks in a private system with individual accounts. Under complete privatization, individuals would bear the full risks and rewards of the investment choices made in their private accounts. In other words, there would be no ready means of sharing risk between generations.

While a privately managed system of individual accounts would allow individuals control over their investments, choice among financial institutions, and flexibility in determining payment streams, a potential downside is that some investors will make mistakes. When they do, they are likely to turn to society for help in meeting their needs. Depending upon the choices offered them, further problems may arise. For example, if lump-sum withdrawals are allowed, some individuals could squander them and then turn back to society for help. Also, if individuals are given choices as to whether they want annuities, individuals who expect to live longer will tend to choose annuities, for which financial institutions will charge a premium.

In theory, many of these risks could be reduced by regulation. Annuitization, for instance, might be required for everyone. A political risk, however, is that the government will not be able to resist demands by individuals who want to withdraw funds early or to withdraw the funds in a lump sum. Such pressures have already reduced the retirement effectiveness of IRA and 401(k) programs.

Privatization proposals that would allow individuals to "keep" gains from private accounts in good times but require the government to maintain a floor in bad times would encourage individuals to take excessive risk. The consequences to the government would be similar to those when the savings and loan financial sector essentially went bankrupt.

At the same time, there are already political risks to the current Social Security system (it promises more than it can deliver) and to the existing private system (these accounts, too, might fail). In addition, the amount of Social Security a person receives often depends on factors outside his or her control, such as when income is earned, health status, the size of wage increases, and so forth. The appropriate standard here is to consider how to allocate risks across generations and individuals in ways that are fair and that take into account the margins at which different people can absorb risks. Providing a core benefit that can be covered through future taxes is one way to provide an adequate guarantee, while individuals can be left some risk through private accounts, whether mandated or, as under current law, voluntary. The debate should be over the proper balance, not whether all risks should be borne either by the young or the old.

Government Control of Investment

Some observers believe that a large equity stake in the trust fund would increase the potential for the federal government to intervene in private capital markets. Others believe it would be possible to develop institutional arrangements for managing trust fund balances that would limit government's ability to exercise undue political influence. Possible models suggested include the current Federal Employee Retirement System, which allows federal workers to contribute savings into private accounts and large state employee retirement systems.

Although interference might be limited through such devices, there is no absolute guarantee that politics would not influence how investments are made. Appointments to boards set up to manage the trust fund could be political in nature—even well-administered and financially successful state systems like the California Public Employee Retirement System have not been entirely immune to political pressures to steer investments in certain directions. In any case, decisions must be made about where to invest. For instance, should investments be made in foreign companies? If foreign companies are excluded, where does that leave international companies like Coca Cola and Sony, which have production facilities and owners around the globe? Similarly, if the board decided to invest only in companies in a broad index such as the Wilshire 5000, would it be wrong for a company whose capitalization caused it to fall just outside that index to seek a proportionate share of government funding for itself? If the surplus to be invested in the public trust fund became large enough, might this not create a bias against smaller companies and new investors in the economy? Finally, there is significant evidence both in foreign countries and in state capitals that pressures continually arise to control investment, such as increases in public works projects or reductions in purchases of tobacco and alcohol stocks.

It is also true that other national and state systems tolerate both funding and some governmental interference. A system with funding will obviously require some mechanism for controlling the assets that are generated. Many of those who favor private accounts simply want to put that control in the hands of individuals; those who oppose them tend to emphasize the risks noted above.

Government and National Saving

Whether adding to deposits in individual accounts or the Social Security trust fund ultimately increases national saving depends on a variety of factors about which there is considerable uncertainty. Therefore, comparisons of different types of plans rest on highly tentative economic assumptions. Indeed, in a number of models developed to examine Social Security, the long-term effect of any plan on economic growth is determined largely by the extent to which changes in the law are assumed to affect national saving. For example, in some models the analyst

by assumption picks the size of government and private offsets to saving through either individual accounts or government accounts, and that choice alone generally determines which plan is projected to yield greater growth through increased saving.

There are two levels at which the saving issue must be examined. First, does a particular policy affect government saving? Second, what are the effects of the policy, including any government saving generated, on private saving?[12]

Government Saving

Although the trust fund is treated as an off-budget item for some purposes, it is included, along with all other federal programs, in the unified budget measure intended to determine the overall balance between federal spending and taxes. A unified budget surplus is in many ways a measure of current government activity in the market, just as a deficit indicates how much the federal government is going to engage in additional borrowing from the public.

One of the indirect consequences of a movement toward individual accounts is that it would change the way in which the government accounts for its liabilities. Under the existing Social Security and Medicare programs, implicit liabilities for the future continue to grow at rates much faster than the net deposits in their trust funds. However, for the most part those liabilities are not recognized in government budget accounting, which is mainly determined on a cash flow basis. The accrual of promises to pay people retiring in 40, 20, or 2 years is simply counted as zero. Only when actual payments are made is the liability recognized. Conversion to individual accounts has the advantage of automatically counting liabilities on a current basis.

This change is not as novel as it might first appear. When the federal government converted from its Civil Service Retirement System to the Federal Employee Retirement System, it replaced some long-term promises of future benefits with current payments into a Federal Thrift Plan. Because these deposits started being paid immediately, they led to an increase in the measure of the current deficit.

As long as Congress enacts legislation with deficit reductions in mind, then recognizing payments to accounts as current outlays could serve as a catalyst for more government saving. Indeed, if Congress wanted to reach the same deficit target before and after such a switch, the money being paid out to individual accounts could lead to a dollar-for-dollar increase in government saving. Whether intentionally or not, Congress feels more of an obligation to pay up front for the liabilities it recognizes than for those it hides.

Generally speaking, current recognition of liabilities is considered to be sound budget policy, regardless of its net impact on saving. Current recognition also tends to discourage excessive promises. On the other hand, unfunded promises that are not recognized cannot easily be recorded as liabilities since they have no corresponding assets (other than the hope that future Congresses will collect the taxes necessary to pay for those promises). Because future Congresses may renege or simply be forced to pare unfunded promises, it is also difficult to know what value to place on these liabilities.

Suppose additional deposits were made to the trust fund rather than to private accounts. To get an idea of their impact on government saving, one can look at what has happened to the net deposits made to date. Currently, the modest surplus being built up in the Social Security trust fund is being exchanged for a special issue of Treasury securities. When the federal government runs a unified budget deficit, it is as if the Social Security surplus were lent to the general fund and used to meet the current cash needs of the government. Because in principle the ability to "borrow" from the trust fund reduces the need to borrow from the general public, the Social Security surplus can cause the unified budget deficit (surplus) to be smaller (larger) than it would otherwise be, assuming nothing else changes.

Whether a surplus in the Social Security trust fund actually causes government saving to be higher than it would otherwise be, however, depends on how the surplus affects other actions. If, for example, the surplus offers greater latitude for government spending in other areas, building up a large balance in the trust fund could leave total government saving unchanged. Historically, there is little precedent for running large unified government surpluses. Even though the federal government may temporarily run a surplus, it does not generally hold net financial assets. For this reason, private accounts may offer a better possibility of permanent retirement saving. Essentially, individual accounts try to accomplish the switch to more saving by giving the money to individuals rather than letting the government keep it.

To achieve roughly the same end, additional direct government saving might be separated out and treated as off-budget. Some off-budget rules have already been adopted by Congress, to limited effect, so newer efforts aim to make the funds "truly off-budget" this time around.

Under a strict interpretation of current budget rules, purchases of equity by the trust fund would be treated as outlays and effectively recorded as having been spent. Consequently, the portion of any trust fund surplus used to purchase private equities would not be treated as increasing the unified surplus. Interpretation of equity

purchases under existing budget rules is still in some dispute, but the rules themselves are likely to be reset under any Social Security reform (Penner 1998).

Counting equity purchases as outlays could affect budget scoring differently than purchases of government bonds do. If the scoring of equity investments made the unified surplus appear to be smaller (or the deficit larger), and if other budget rules intended to hold down spending were still in force, it is possible that investing the surplus in equities would cause other spending to be reduced or taxes to be maintained at higher levels.

Many of these investment questions would not matter in the short run if Congress were to adopt and keep to a deficit target that excluded additional saving in the trust fund. In that case, whether the Social Security surplus was invested in equities or government bonds (or corporate bonds and other investments as well) would make no difference. Any Social Security saving would add to government saving simply because it was being treated independently.

Formally defining Social Security as off-budget, however, presents a host of problems. The treatment might be appropriate if the system were to be fully funded, but this is not the case. In fact, Social Security is now designed to remain significantly dependent upon general revenues and on-budget sources of funds. Reliance upon the rest of government is a natural consequence of its trillions of dollars of unfunded liability.

The interactions between Social Security and the rest of the budget would increase immediately if Social Security received a grant of bonds from the Treasury, as proposed in 1999 by President Clinton. Once the bonds were accepted, subsequent interest and principal payments would be made by transfers to Social Security from general revenues—again making it difficult to think of Social Security as being off-budget. In effect, President Clinton's proposal was to infuse on-budget funding into Social Security.

Programs for the elderly are already heavily dependent on funds other than Social Security taxes. Social Security itself receives significant on-budget funding, including an infusion of general revenues from the taxation of Social Security benefits. Other programs, such as Medicare Part B, are funded with the help of substantial general revenues. As a whole, these programs would be running sizable deficits if their spending were limited to what they receive in Social Security taxes. In sum, *it is difficult to design a rule that takes Social Security off-budget for some purposes some of the time.*

Finally, whatever the short-term gains for saving achieved by taking Social Security off-budget, they could be reversed in the long run. Under current law and many proposals for reform, Social Security will move away from its temporary situation of surplus to a more permanent one of deficit. Once Social Security starts paying out more in benefits than it takes in in taxes, it will begin spending the interest it receives on government bonds. This will effectively put it in a deficit situation. The goal of those who have traditionally advocated putting Social Security off-budget was to deter government from using the temporary surplus for current expenses outside of Social Security. If future Congresses aim for a non–Social Security deficit of zero once Social Security starts running large deficits, then government as a whole would again be running large unified budget deficits. The fight then would probably be to put Social Security back on-budget so that the full fiscal impact could be understood.

In sum, individual accounts directly encourage government saving to the extent that they recognize liabilities currently rather than waiting until cash payments are actually made. Alternatively, when saving occurs within Social Security, budget accounting can be changed to try to deter Congress from spending those funds. The difficulty in the latter case is that strong fire walls are required; they could create problems when Social Security moves from surplus to deficit, and efforts to insulate Social Security might deter needed trade-offs among the various programs for the elderly.

National Saving

Sometimes it is presumed that an increase in government saving will automatically translate into an increase in national saving. In fact, the historical evidence is mixed. Since World War II, increases in government saving have increased the amount of money available to be borrowed by the private sector (Steuerle 1990); however, much of the increased borrowing takes the form of secondary mortgages and credit card debt. That is, private borrowing finances consumption as well as investment. The simple assumption that government saving translates to private capital investment and net national saving simply does not hold.

Additional deposits to individual accounts do not necessarily increase national saving either. Here again, one runs into the economic fallacy of assuming that if one part of an economy puts aside more money, it will be translated into a dollar-for-dollar increase in net saving for the economy as a whole. However, a person required to make deposits to an individual account may choose to reduce his or her deposits to a 401(k) or other retirement saving. Another person might increase his or her borrowing on the strength of the additional deposits. As noted above, increased government saving seems at times to have led to expansion in consumer borrowing. The same is true of increases in pension saving, which have helped finance credit card and secondary mortgage credit.

Individuals might think of themselves as saving more because their individual accounts rise in value without ever noticing that their mortgage debt was being paid off more slowly or that someone else was borrowing their money for purposes other than investment.

One group likely to save more is people who have little saving now and, because of fewer assets, limits on how much they can borrow. In that sense, individual accounts could lead to a greater equalization of wealth in society and an expansion of saving to more households. If low-income persons can also be protected with a basic Social Security system, they could end up with a greater share of both public and private wealth, regardless of whether net saving in the economy as a whole increased.

Individuals are likely to save more if they think government will provide less of what they want (Penner 1999). For example, many reforms would slow the rate of growth of Social Security benefits provided from pay-as-you-go financing. Such a slowdown would increase the amount individuals need to save for retirement consumption or income. On the other hand, some reforms—whether involving individual accounts or additional trust fund saving—promise individuals that they would receive as much as, if not more than, Social Security currently promises. Such reforms would probably lead to further offsetting decreases in private saving. In comparing the impact of various reforms on private saving, therefore, it is crucial to see how much the reforms promise in transfer payments in the future.

The principal threat to national saving today is the large Social Security deficits looming in the future. Under current law, the main gain in national saving may come not from increases in individual deposits or saving within the Social Security trust fund, but simply from avoiding those deficits. To a large extent, the economic implications of all proposals to reform Social Security funding depend on whether they succeed in increasing total saving. If advance funding of any type yields no additional saving, the net result may be simply to give retirees a higher claim on the resources of younger generations. If mandated contributions to private accounts are combined with benefit cuts, but the mandates merely change the form of private saving without increasing the amount, the income of many future retirees could fall significantly.

Work Incentives and Distortions

Numerous other incentive issues come up when comparing individual accounts to additional trust fund deposits. Sometimes these differences arise more from the design of the alternatives being considered than from any actual difference between the two types of saving.

Social Security can create a disincentive to work beyond retirement age because older employees' additional taxes do not result in an equivalent increase in benefits. Privatization may encourage individuals to work longer because they receive higher net after-tax compensation for their additional effort.

As long as the system redistributes income, however, some net taxation cannot be avoided. In theory, the same amount of redistribution can be achieved with a partially privatized plan and one with government saving.[13] Some aspects of Social Security redistribution unnecessarily compound the net tax, but most of these could be resolved as long as other reforms accompanied them. Three examples follow.

First, the existing system's bias toward rich rather than poor spouses, regardless of child raising or taxes paid, tends both to raise tax rates and to make benefits much less closely tied to earnings than they would be if the redistribution were targeted to those with low or modest earnings.

Second, because the existing system provides almost no return to secondary workers in families, it discriminates against the very group that economic theory indicates is most responsive to work incentives. Individual accounts have the advantage of treating secondary workers on an equal footing with primary workers, thereby enhancing the work incentives for this group. On the other hand, privatized accounts are not well geared, by themselves, to redistributing benefits to those with lower lifetime earnings or poorer widows and widowers.

Third, the existing system does not count all years of work. There is a faulty notion that this practice helps achieve redistribution to those who are poor because they were out of the labor force for years, but in fact it also discriminates in favor of those who want more leisure or who go to graduate or professional school for many years. Moreover, it simultaneously puts most people into a situation where additional work and contributions provide a net yield of zero. While individual accounts deal cleanly with this issue by treating all work equally, the Social Security system can easily be reformed to achieve the redistributive goal by counting all years of work and then changing the benefit formula to protect lower-earning individuals in general rather than simply those with fewer years of work.

Administrative Issues Raised by the Third Pillar

Many administrative issues are raised by creating the third pillar, especially if the mandatory savings include some private ownership. This primer notes a few of the most important issues.

Any government subsidy of retirement saving will be regulated in an effort to ensure that the subsidy goes for

its intended purpose, but this raises the question of how government stops individuals from tapping into those funds for other worthy purposes, such as education. Traditionally, government has had trouble restricting retirement saving to retirement, as is reflected in its experience with people borrowing or withdrawing from private pension saving and individual retirement accounts.

A related issue is whether any funds owned by the individual would have to be annuitized. If not, people could spend down their funds in the early years of retirement and then turn to the government for assistance through other programs, such as Supplemental Security Income and Medicaid. There is no consistency among proposals for privatization in how they treat annuitization. Moreover, many proposals that do not require annuitization have no plan for obtaining additional funds to support the systems that would be tapped in its absence.

Other regulatory efforts may be needed to try to protect individuals from getting too low a rate of return on their private accounts. Chile has adopted a system in which individuals may choose plan administrators, but since successful plans must subsidize less successful ones, returns among them do not vary too widely. Other options for privatization try to restrict the mix of stocks and bonds that individuals can hold.

It has become clear that the administrative costs of privatized systems vary widely. Lawrence Thompson has argued that many of these differences arise from whether "salespersons" are allowed to sell alternatives, or whether options are restricted in such a way that the costs of these salespersons can be avoided (Thompson 1999).[14] For example, many plans allow only a few options, usually to buy some index funds. Some competition may be allowed among administrators as to who can offer such options.

Once options are allowed, the costs of a privatized system almost invariably rise relative to those of a public system with little choice. The differential can be exaggerated, however. Any monopoly is efficient at some level relative to competitive suppliers. Thus, one could argue—perhaps even more strongly—that letting the government supply life insurance, bank services, automobiles, or perfume would involve lower administrative costs. One difficulty with a monopoly supplier is that its design choices tend to become inflexible over time. Another is that some of the saving it achieves is through inequities that would not be allowed in a private system. For example, under Social Security today, a divorced person has no right to share a spouse's benefits if they are divorced within 10 years of marriage, but that person is subsidized by the rest of society, regardless of need, if they are divorced after more than 10 years of marriage.

SUMMING UP

As long as it is considered proper to maintain an unfunded but mandated system and a funded but nonmandated system, it is difficult to argue against a hybrid—a funded but mandated system—as a third pillar supporting retirement. As a general matter, adopting a third pillar does not increase the aggregate rate of return in either a pay-as-you-go or a funded retirement program. If returns (rather than rates) increase, it is because the amount of saving or funding increased. To increase net benefits to one group or to future generations, some other group is going to have to accept less initially. This may be fair or unfair, more efficient or less, but no magical returns are possible.

Because of its focus on saving, the debate over privatization or additional funding within Social Security tends to hide the nature of current and projected shortfalls. Demographic shifts will cause imbalances within Social Security, and the rapid decline in taxpayers relative to beneficiaries will have significant economic repercussions even if saving increases. Shoring up Social Security requires getting benefits into line with revenues, but trying to add to saving may also be a valuable goal in an economy that hides the costs of its retirement promises and generates little private saving.

The transition to a new system is made difficult by the extraordinary number of promises made to support so many people in the future. When the ratio of workers to beneficiaries is small in a pay-as-you-go system, it takes a substantial share of workers' income simply to maintain basic guaranteed benefits for those already retired. For transitional generations, contributing to their own retirement saving becomes an additional cost. Despite this difficulty, there is a precedent for workers paying twice to bring a retirement system back into balance: the transition from an unfunded to a funded private pension system.

In comparing private and publicly funded systems, several issues come to the fore. The principal political debate is probably over redistribution, but it is entirely possible to maintain or even improve upon the existing redistribution to low-income elderly in a partially privatized system. Opponents of individual accounts contend that future voters would not want to support a redistributive system, even one that helped the poor more, if they saw what was available in a system without redistribution.

A switch from government bonds to stocks produces no magical returns in either a public or a private system. Risks arise in any system with new saving; that risk should probably be allocated to those who can best bear it, rather than simply putting all of it on either the old or the young. Government control of investment would raise many contentious issues. Those who favor private

accounts believe that the best solution is to give the power to individuals, but even those who want government to hang onto any saving recognize the need to try to build some walls between the Social Security trust fund and the rest of the federal budget.

The extent to which any reform would increase saving is highly contentious. It is simplistic to assume that a government mandate to save in private or public accounts will translate into a dollar-for-dollar increase in total national saving. Some analysts believe that a funded system would have a greater chance of raising private saving if it were combined with real cuts in unfunded benefits. More fruitful than trying to predict saving outcomes would be efforts to assess which proposals are most likely to improve upon budget accounting, make costs recognizable, and distribute saving more widely among the population; reform based on such assessments would less likely be dependent on promises that could not be kept.

Many of the incentives of the existing system distort behavior; they could be improved by adding a third pillar, regardless of whether it mandates private or public saving. Finally, any privatized system is likely to involve some regulation. Higher administrative costs, for example, cannot be avoided entirely in a system with individual accounts. Most proposals try to limit these costs, mainly by restricting options and avoiding large costs of sales.

ENDNOTES

[1]The objective of generating increased saving for retirement is separate from that of restoring a balance between promised benefits and taxes. Restoring fiscal balance to the system would increase national saving to the extent that it lowers future projected deficits, but it would not require households to lower current consumption over and above the amount needed to make the Social Security system solvent.

[2]Steuerle and Bakija (1994) argue that the system has often been "regressive" within generations because large windfalls accrued to wealthy households and households with one high-earning and one zero- or low-earning spouse. Coronado, Fullerton, and Glass (1998) argue that the system's progressivity is reduced because of the presence of relatively low-earning spouses in wealthy households and because low-income workers have a lower life expectancy.

[3]This point was made by Samuelson (1958), who showed that under some conditions participating in an unfunded pay-as-you-go system could be economically more advantageous than having each generation save and invest for retirement. Roughly speaking, the required condition is that the rate of growth in the workforce plus the rate of growth in the productivity of workers exceed the return to private capital. This condition is not met by current or projected rates of growth in the workforce and labor productivity. Note, however, that the Samuelson theorem was not dependent on the value of the initial transfer made. One could have thrown the money available to the first generation in the river, and Samuelson still could have said that every succeeding generation ends up better off and the first one no worse off.

[4]In practice, Social Security doesn't base the transfer on past transfers but on past earnings subject to tax, which complicates the matter somewhat. Nonetheless, the basic point remains. The amount that current generations of workers can expect to receive ultimately depends on the extent to which future generations are politically willing and able to make transfers.

[5]We are ignoring here whether a larger capital stock might change the returns available to each piece of capital.

[6]Proposals to increase tax rates further would raise this return only for the next generation of retirees, after which a similar decline in rate of return would occur. Moreover, any temporary increase in the rate of return would probably involve only a fraction of a percent. (Keep in mind that with redistribution, people with higher earnings will get an even lower rate of return than the average, and people with lower earnings will get a higher rate of return.)

[7]A balanced and detailed discussion of the issues involved in advance funding and privatizing Social Security may be found in National Academy of Social Insurance (1998).

[8]To the extent that the cost of funding private pension plans was not fully shifted to workers in the form of lower wages and salaries, it may also have been borne by business owners and holders of corporate equity.

[9]This type of contingent liability should be distinguished from that which would arise in some plans to privatize, such as the Feldstein-Samwick proposal, which explicitly guarantees that participants would receive no less than the full benefit promised under current law.

[10]Distributional objectives could also be achieved by subsidizing contributions made into individual accounts, as in the case of the Clinton administration's proposal to use part of the surplus to create universal savings accounts or the 21st Century Retirement Security Act recently proposed by Representatives Jim Kolbe and Charles Stenholm.

[11]This analysis makes the common assumption that an advance-funded public system would be administered as a defined benefit plan. A different sharing of risks—more like that found in proposals to establish individual accounts—would result if such a system were administered as a defined contribution plan in which retirement benefits were commensurate with tax payments made.

[12]For a general discussion, see Engen and Gale (1998).

[13]As noted earlier, redistribution could also be accomplished by subsidizing contributions made to private accounts.

[14]The administrative costs also depend on factors such as the range of services provided, reporting of results, amount of trading undertaken in accounts, and so forth.

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URBAN INSTITUTE

2100 M Street, N.W.
Washington, DC 20037

Phone: 202.833.7200
Fax: 202.429.0687

e-mail: paffairs@ui.urban.org
http://www.urban.org

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