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Prospects for Social Security Reform

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The topic that we need to talk about is basically the question of social security. What I would like to do is spend a couple of minutes discussing some of the conceptual problems with social security. Then what I will do is speak a little bit briefly about the commission on which I served and some of the proposals that we came up with. Then what I would really like to do is to allow some time for you to ask questions or challenge anything I might say. If you are interested, we have a website. We have a lot of working papers, different studies that you may access at your leisure.

The first question we think about when we think about social security is what is its purpose? What is its objective? Of course, the original intent of the program, and I think its current intent as well, is to try to protect against retirement insecurity. That is to try to put in place a structure whereby people can look ahead to retirement with some degree of confidence and sense of security. When you talk about old age security the first thing you have got to debate is what is old age? I know my definition is twenty years ahead of my own age and so I will never get there, and I hope you all have the same working definition. But in fact the definition of what it means to be old is quite controversial politically. I was working recently in Chile and there, for a male to be eligible for social security, to be old it is age 65. For women it is 60. I thought, well that seems a bit discriminatory. The argument there is that women have worked so hard all their lives to do their regular job and their home job that they deserve to be out early. What that really shows is that the definition of old is a definition which each society constructs based on culture and ability to pay. I think one of the real key topics that I hope you will bring back to the floor later is should we change the definition of old?

Right now in the U.S. we have been living with the definition of age 65 as the age at which you are entitled to get your full social security benefit. As you know, the Greenspan Commission twenty years ago started raising that definition of old age to 67, and so what is old-old? Does anybody know? What is the definition of old-old? 85 is the definition that has been coming into play. Who knows what the right definition is? There are people now at the University of Pennsylvania, I am sure here as well, that are trying to cure aging by doing genetic manipulation and so forth. So this is a very flexible notion and I think we need to keep this in mind as we go forward.

What is the risk that people seek to protect against? Number one is the risk of living too long, that is, you do not want to outlive your assets. That is a very important component of old age security. The other issue is, of course, poverty and old age. You do not want to be in a situation where you have inadequate income to support your life style. So here is the traditional life cycle model. So what you have here, this is the life cycle model that Modigliani and Ando won the Novel Prize for. Over your lifetime you have some projected earnings path and if you eat all your earnings and do not save anything, then you do not have anything to live on after retirement. So that is that. Now what you have with the notion of consumption smoothing is that a rational individual that is forethoughtful and foresightful will consume less than his entire earnings, building up some assets and at the point of retirement can start drawing them out.

What is the role for a pension? The role for a pension is to help you save for that which you know you need to do. That is you are going to be consuming in retirement and the pension helps you achieve that saving target. So you build up your savings through a pension or private savings and then you move to retirement and consuming. If you are very forethoughtful you can do all that without a social security system. That is you could do it on your own in a perfectly rational model. But some things intervene, for example, people are impatient, they forget to save, maybe they are not very successful at saving, maybe they do not know when they are going to retire. They do not know when they are going to die. There is lots of uncertainty in the world. So the notion behind the social security system is that it helps you protect against retirement insecurity. I think that is really what our system has been set up to do.

As you probably know it was set up during the Great Depression by FDR and today it is the single largest U.S. government program. Which gets back to Steve Smith's comments that if we do not fix this then we have very little hope with regard to the rest of the economy. It is a national, mandatory system as you know. We call it, for short, the OASDI system. It is Old Age, Survivors and Disability Insurance system. It is what we call a defined benefit program. That is, there is a formula that tells you what your benefit is, and it is primarily financed by payroll tax, as you all know, your FICA tax. The revenues are enormous, right. So you talk to people at the social security administration. They are taking in $627 (give or take) billion per year and it's mostly collected in the form of payroll taxes, half of it employers, half of it employees. What most people do not realize is that the payroll tax is actually a bigger tax for many, many American workers than is the income tax. So it is a very significant chunk of people's income. It averages about $4,100 per year per worker. Now if you are sitting there with the social security system's hat on, what you have to do then is look at the cost of the system. The costs of the system speak to the benefits that are being paid out and that is a big number too, $462 billion and rising. This gets paid to about 47 million recipients, the retirees, the survivors and so forth. The average benefit they get is about $9,800 per year so it is not a lot of money. I think that is important to remember when we think about the objectives and the way the system needs to be reformed.

Now the problem, of course, is that there are many, many goals for social security and they are not mutually consistent. There is tension between them. One of them is clearly to provide longevity insurance. That is, we want to make sure people do not outlive their income. So even if you live to be a 100 or beyond, which is now feasible, we want to make sure you have a real annuity that keeps on paying you in retirement. There's also the social assistance feature of social security. That is, if you've been poor all your life, or maybe you haven't, maybe you've just run out of money, then there's something there to pick you up as a last safety net. Some people argue, in fact, that the system ought to become purely needs tested. That is, only conditional on being poor would you get benefits.

Social insurance is the other aspect of Social Security that speaks to the question of insurance, you get back what you pay, in essence. They are the benefits that depend on past earnings. If you have paid more, you get more back. If you have never contributed, you do not get a cent. So you understand that these three objectives are not necessarily mutually consistent. As I said, the system is mostly pay as you go now. There is payroll tax levied on employers and employees and the total now is 12.4 percent. For those of you that are thinking, well I think the numbers are higher than that, of course, there is another percentage that goes to pay for Medicare. The social security piece, the retirement, the disability piece is only levied on pay up to $87,000 a year. Above that, you pay no additional social security tax, but you do pay Medicare tax, of course. It is a big chunk of change.

Now what is the problem? This is the graph that really says it all, I think. The fact is the social security system is running out of money. How do we know? We know that because we can project what the revenues to the system are. That is the purple, relatively flat line. The revenues to the system consist of the payroll taxes that are being levied on all the workers in the economy and they are not projected to grow at a very fast rate. Why? Because the labor force is not growing, the rate of productivity is relatively small and so this is a projection of the revenue coming in. The blue line, which starts low and goes up high, consists of the cost that the system pays. In other words, the benefits that are going perhaps to people in this room, my mother, to retirees everywhere. Right now we have, as you noticed, a good situation. The costs are below the revenues. What do we call that? Surplus. Where does this surplus go now? It goes theoretically, technically, into the trust fund. That means the social security system takes the surplus to Treasury, Treasury then issues a special issue bond to social security, which is an IOU, and then the money goes to Treasury and Treasury spends it. So that is sort of the short story.

Now at some point, these are government guaranteed bonds, so at some point treasury will have to redeem the bonds. In fact, starting in 2018, according to the trustees there will be insufficient cash coming in to pay for social security benefits so the bonds will have to start being redeemed. At that point social security will present to Treasury — there is currently something like $1.9 trillion worth of bonds in this special three-drawer file cabinet in Virginia that holds these bonds and they are non-negotiable set by the interest rate by the Treasury. At some point the social security system will come in and present the bonds. The Treasury will have to come up with the money.

Where does the money come from? One possibility is the government could raise taxes, so that is a source of funds. What is another possibility? They can borrow. Inflation, not necessarily because the social security system is all inflation indexed so it is not going to help a lot. They can borrow the money, they can raise taxes or they can spend less on other government programs to funnel the money into the social security system. But those are really the only three choices. Some people say well, you really ought to focus on 2018. Now 2018 is just around the corner; that is the problem. It is not forty years from now, or sixty years from now, it is about fourteen years from now that we start to think about this issue. If we wait until 2018 then gradually, inexorably, the social security system is going to take a bigger and bigger claim on tax revenues or other sources of funds and it is going to become a problem.

Now in 2042, what happens then? The three-drawer file cabinet is empty; the trust fund is exhausted according to current projections. At that point you really have a problem because there is no source of revenue that is dedicated to paying benefits. So in 2042 you have a couple of possibilities. Either benefits will have to be cut substantially or taxes will have to be raised substantially. Otherwise the system has no recourse, it has no place to go. If you compute the present value of the non-funded liability that the system faces it is currently on the order of about $12 trillion. So is $12 trillion a big number or a small number? What do people say? What is the size of the GDP right now? Ten trillion. So it is bigger than the whole GDP of the whole U.S. Now this is the present value, of course, and nobody is saying you have to pay off social security in one fell swoop overnight, but it is a big number. It is a big debt. In fact it is the type of government debt that is not publicly recognized. It is not part of the government surplus or budget deficit every year. It is a huge debt which is not recognized officially. You can actually compute it but it has never been part of the public discourse.

Now the problem is this debt, this unfunded liability, I believe, poses massive risks to the system. And so when we went back and said what is the purpose of social security — to try to enhance your retirement security — this really undermines security quite substantially. If you do nothing, what happens? Benefits have to be cut by between a quarter and a third. Now myself, I will probably be around in 35 years and to face benefit cuts of that magnitude is very unappealing. The other possibility is, we can just raise taxes. I am thinking, this is my kids that we are going to be raising taxes on and my grandchildren that I am going to be raising taxes on. We will have to raise taxes a lot, by 50 to 80%. The question is that: a) is it fair? and b) is it politically viable that we will be able to do that? So the problem is that every year we wait, things grow worse.

How did we get into this problem? Well there is lots of ways and perhaps it is not even worth crying over spilt milk, here we are. But the fact is the benefit promised from the time Roosevelt instituted the program, the benefit promises were expanded, extended, made more generous. Heaven knows there were a lot of poor folks around during the Great Depression and it is sort of inevitable that this money would be used to pay greater benefits. People are retiring earlier and earlier. What is the average local retirement age in the U.S.? Sixty-two. Why is it 62? Because that is when you can get your early benefits. People have taken this notion of early retirement as a mandate, as a strong suggestion from the government and they are facilitated to retire early. Of course, they are retiring early despite the fact that they are living longer and so we are covering people for longer and longer periods of time and the system can't do that anymore.

There was this large baby boom, as you recall, the cost picture that started out low and went up high, that is because everybody in my generation is getting ready to retire in the next ten years. That also is driving up the future costs. Finally if you stop and look a little bit at the benefits formula what you realize is that benefits under the current system are tied to wage growth. So every time wages grow by a percent, let's say because of productivity, benefits also go up in exactly the same step. Now the problem is that wages can grow in percentage terms but that doesn't mean you have the tax base to pay for benefit increases. So if benefits were tied to prices not wages then it would be a much more affordable system, as I'll tell you in a moment.

Also, we have falling fertility and we're not in such a bad position here in the U.S. because we are still around replacement in terms of fertility. People are having about the same number of kids as they need to replace themselves. I just came back from Italy. They have 1.2 babies per woman and you need 2.1 to be a replacement so the population is shrinking in Italy. It is shrinking in Germany, and heaven forbid the French are also shrinking. That makes them very nervous. That's a big topic of conversation in France. What are we going to do when our population shrinks? Unemployment has been a problem and also productivity. We don't really know how to increase productivity very successfully.

A couple of words about the commission, the Commission to Strengthen Social Security. Please go to the website (www.csss.org) in case you can't sleep one night and want to go read the final report that we proposed. It is very interesting. When I was asked to be on the commission there were some very clear guidelines that were given to us as the constraints in which we had to work. The first one made a lot of sense: "Don't make things worse." That seems like a no-brainer right? But I can tell you that lots of proposals that we get from Capitol Hill and various other folks from around the country actually make the system in worse shape rather than improving it. So that didn't seem like a good place so we happily agreed that we were to improve the system's fiscal and financial sustainability.

The second requirement and I think, I'm an economist not a politician, this makes sense: "Don't cut benefits for retirees. If you ever want to get reelected you're not going to cut benefits for retirees. It is just not feasible. Then the other component that the President asked us to do is to not change benefits for near retirees and we interpreted that as people 55 and older. They are under the old system. They're not going to be affected because it is just to disruptive for people to be thinking about changes in their retirement programs near retirement.

Another charge was don't raise social security payroll taxes. Okay, so you can't cut benefits, you can't raise taxes. You have to get a little creative here. At this point we have few degrees of freedom left. The key factor that the President really wanted us to include is offer voluntary, not mandatory, but voluntary individually controlled personal retirement accounts and I'll talk more about these in a minute.

The structure is bi-partisan, eight democrats, 8 republicans. We had the late Senator Daniel Patrick Moynihan as one of our chairs. Richard Parsons from AOL Time Warner. I think now they are just Time Warner. Of course, throughout this whole discussion every time we came up with a proposal we had to take it to the actuaries of social security because it is very important when you look at these policy reforms to use a common set of assumption. It is not fair to get in and propose some changes and use arbitrarily wild assumptions to get your results.

So what were the plans? There were actually three plans that we proposed. I'm just going to focus on the second one because that is the one I like the best. The key element to this proposal was to change the structure of the traditional social security system so that benefits would be indexed not to wages which is what is driving the system into insolvency but link them to prices. So the very important result of this would be that benefits would never be cut in real terms. Benefits would always be at least as high as they are today. They'd have the same purchasing power, but they would not keep going up ever faster than prices which is what has led to our problem.

Now that single change, price indexing the benefits instead of wage indexing the benefits, has a profound effect. That in and of itself is enough to balance the system and in fact come up with some extra money as well. So that's what we did in the second step. We wanted to enhance the safety net of the social security system for people at the very bottom.

Now some of you might not know there is no benefit, minimum benefit under social security. That is, if you've been a minimum wage worker and you've paid into the system your whole life, you're not guaranteed at least a minimum poverty line benefit under social security because the benefits will be very low. So since we has some funds left over from the first step we could apply them to the second step to make it a better safety net for people at the bottom. So we proposed boosting lower minimum wage earner benefits not only to poverty but 20% above the poverty line.

Also, the second group that people care a lot about is widows, and of course we're non-gender focused so we can do widows or widowers, it doesn't matter. But the point is, if you're a surviving spouse a lot of people hit widowhood and they end up in very bad straits, so this would boost the surviving spouse benefit to 75% of the couples benefit, if they were below average. It wouldn't help the rich folks so much but it would help the people at the bottom. Of course, as I said, we had to have a personal retirement account. That was something the President insisted on and we all agreed that we would work within the structure of this to begin with. The plan we proposed had to have some elements, key elements.

Number one, it had to be voluntary. Why? Because it was the politician's belief that if you made it mandatory it would never fly, but once you make it voluntary you have to make it attractive enough so people actually want in. You can't make it a really unpleasant voluntary benefit or people wouldn't opt for it. So what we proposed was a plan where you could put up to four percent of your current wages that are now going into payroll tax. You could rededicate a portion of that payroll tax and put it into funded, invested, defined contribution style accounts up to a $1,000 and this would rise over time, if you elect the personal retirement account.

So if you decide to redirect some of your money out of payroll tax and put it into your account, well surely you can't get the full benefit under the old system because you haven't contributed your share so there has to be some offset. The way we thought about the offset is if you do elect this personal retirement account, the traditional benefits would be offset at a two percent real rate. So the way to think about this follows: If you think by investing in the personal account that you could earn at least two percent real rate of return, which I think most people think they probably will, then you would be better in the personal account. So that was good, the structure that we proposed, and there are many variances on this. It is not the only approach but I think it is an illustrative one.

What happens? With the first component, with moving to price indexing instead of wage indexing, immediately you get the two lines to cross — well not immediately but within the period that we're looking at, which is a 75 year window. That's what the social security actuaries require us to use. You get the two lines to cross. In fact there is a little bit of a surplus so that helps fund the basic benefits. Why price index? In our judgment, price index was actually a fairer system because over time wage indexing increases higher wage workers' benefits more quickly than lower wage workers' because it is a percentage increase on a percentage increase. Under the old system, under wage indexing, higher-wage workers did better and better. Lower-wage workers didn't do so well. Where as under our system, people at the bottom would do quite well as I'll show you in a minute.

A couple of comments about the structure of the personal accounts: if you didn't want to play, you didn't have to do it. That was always optional. If you did, we would propose that the payroll taxes would continue being collected in the same way they are now. That is centrally, through the government just like we do it so not to waste a lot of money on expenses. The benefits have a particular structure. Most importantly, we agonized over this because after all it is your money maybe you should be able to take it prior to retirement, and so the concern was that maybe if we let people take it early then they would spend it, waste it and not have any money in retirement. So we required that you would have to keep the money in the account till retirement, that at retirement you would have to annuitize part of it. That is you would have to buy a minimum income benefit for life just so you didn't go blow it all, take the lump sum, go to Hawaii and then come back with an open hand and say pay me.

It would be an asset divisible in divorce. This is actually very important because under the current social security system many women end up with nothing. Why? Because if you're not married for ten years under the current system you get no benefit from your husband if you end up getting divorced prior to ten years. So I always tell my students, look you're young, you have a bright future ahead of you but we know 50% of the marriages in the U.S. end up in divorce so stay married for ten years under the current rules or select a personal retirement account which would be divisible in divorce.

Investment choices again were very interesting because, don't forget we were doing our deliberations, our commission was meeting in the year when several fairly tragic events happened. 9/11 happened, Enron, WorldCom, Tyco — it was not a good year. The stock market crashed. So immediately people said well we don't want to let people invest in their own company, 100% in their own company. We have to protect against that. So what we decided to do is to propose a model akin to that of the federal government's retirement system, the thrift saving plan. It had basically a few diversified funds. A stock indexed fund, a bond indexed fund, you could choose within that family but you could not pile all your money into your own company's stock. After all, this is still social security. If you chose not to choose, if you couldn't make up your mind, then we needed what we would call a standard portfolio and we just proposed a 50/50 stock bond mix. But you could choose anything else if you wanted.

Now the question is would folks in the private sector like to manage the money? Initially we were roundly criticized by saying this is just a bigger money maker for Wall Street. Wall Street is going to get this money and invest it and get rich on it, and this won't work at all. But it turned out, much to my surprise, Wall Street was not very interested in these accounts early on. You know why? Expenses. You have little bitty accounts. People are putting in 50 or 100 or 200 dollars a year in the beginning, low-wage workers. They don't want these accounts. They're very expensive to manage. So the notion was it could be operated much like the thrift saving plan is now, centrally, and then once the system was familiar and people got used to it, people had experience with it, perhaps licensed competitors would be allowed to enter the program. This would be costed at a very low rate, 30 days as points, probably less, probably more like ten.

So how does the system play out in terms of projections? This graph indicates anticipated benefits for low-wage workers under the current system which is the first bar. Low-wageworkers are getting $637 a month. That is what's currently received. As we go forward the current system using existing taxes, that is without raising taxes any further, could in the future provide a little bit of a boost, $700. What is actually promised under the current system but can not be paid is $986 per month. So the current system is promising much more than can actually be paid. Then the question is what would you get if you paid into the system for your whole career, into the personal account system? You've got your basic benefit under the continuing social security system, you got the personal retirement account.

The issue is what did you invest in? If you invested in a low yield that is only bond fund, if you invested in a high yield that is only stock fund, or the middle one, 50/50. It all depended on projected expectations of market returns but what we anticipated is that actually in all three cases you could expect to make more certainly than today's benefit, more than what is payable under the current program, and at least in a couple of the cases more than what is promised but can't be paid under the current system. So it really did seem to us and it seems to the actuaries that most people would choose this plan, most people would do better under the personal retirement account variation than not.

Now you could say, well this is great, this is if you opted for the personal retirement account. What if you didn't? It's still a voluntary model. What if you opted to stay only in the old system and didn't opt for the personal account? This is a little bit of a complicated graph that you are looking at but let me just point out that today's benefit level is the blue dotted line. The plan to go with personal accounts is the top black dotted line, so clearly higher. The purple line that has a notch in it is what you would get if you stayed in the current system and then when it ran out of money you'd just experienced a big benefit cut. So that's what would happen under the current rules and if we made the change to the system and you did not opt for the personal account. You would get the brown line. So in most years, for most retirees, people would do better and you wouldn't suffer this big uncertainty of not knowing how much benefits you were actually going to get.

What about other financing issues? Of course, at the end of the day, people want to know how much is it going to cost, is it going to work? The most important question is do you get to a positive cash flow? That is if you are always in debt, if you are always running a deficit, than obviously that's not a sustainable system. The answer is yes, we run a positive cash flow and we do it over the 75 year window the social security system always uses for scoring these things. Do you restore actuarial balance? The answer is yes, almost. We restore two thirds of the actuarial balance within the 75 years and it quickly is 100 percent restored out a little bit further, if you push the 75-year window out a tiny bit.

How much is it going to cost? It is not cheap but it's a lot less expensive than our current system. That is, it would cost about one half a percent of GDP when you need it or about less than one trillion dollars in present value. What are the unifying themes? I think the most important thing to mention is that we did not propose full privatization of social security. Now some folks would criticize us because we didn't propose full privatization of social security. My husband is a libertarian. He said you should have shut it down. I just don't think that's politically feasible in this day and age. In fact in most developed countries it's probably not. We maintain a very strong first pillar attack, a better safety net than we have now, no benefit cuts. It's very important. A lot of critics were going around saying "oh you guys are cutting benefits." Wrong, no benefits would be cut. They'd be at least as high as today's, probably better and the safety net would be better, better benefits for lifetime low wage workers and survivors.

The President emphasized often that he wanted to put in people's heads a mechanism of building wealth. That is really what he saw as the prime political appeal of this program and also it allowed better investment diversification. Right now a lot of people only have social security, that one asset if you will, and it's a very risky asset because it's running out of money. By having personal accounts you diversify across different retirement vehicles and also of course you get to choose your investment within reason. It's more transparent. The benefits would be better related to the contributions. At the end of the day, then who will benefit? I think everybody would actually benefit from a better social security system knowing that the system is running out of money fifteen, twenty, thirty years hence. It's very important when you're trying to make your own retirement projections, retirement decisions, retirement savings and how much you spend during retirement.

If a big portion of your retirement security is, in fact, insecure it's not very encouraging. Half of the work force currently lacks a company pension. This may be a critique of our corporate pension system but half of them don't have one. Whereas a personal account would actually give them some stake and help them diversify. They could also be inherited which is something that is not feasible under social security today and it helps, as we said, the low income worker, women and minorities.

So at the end of the day what do we worry about? The problem is, every year we wait and do nothing we've lost the golden opportunity. We've lost the year where there's actually a surplus to do something with. Every year we wait a good year is replaced by a bad year. This is an unfortunate reality. Of course other things are happening. Life expectancy keeps going up, birthrates remain low.

Some folks say all we have to do is open the gates and let immigrants come in and then the immigrants will replace the babies that we're not having. That's a pretty Draconian suggestion because you'd have to fantastically increase your immigration rate and you'd have to totally change your immigration policy. Right now our immigration policy has been essentially family reunification and political refugees. So you would have to get rid of that policy and basically only let in people with a certain level of education, a certain age. You'd have to completely change the policy. Productivity growth. Some folks say all you need to do is increase productivity. Well, we have smart people in this audience, what's your favorite way to increase productivity? We don't really know how to do that? So it's not a silver bullet because we don't know how to control that. As we proceed, the shortfalls just loom larger.

I want to have some time for comments and questions. I guess the main thought I want to leave you with is that it is a fact, social security is not sustainable, it's not a political argument. It is simply running out of money. That's just a black and white fact. That doesn't mean you have to run off and say there's a crisis coming but it does mean you have the opportunity to do something now to help better the situation for the future. I believe personal retirement accounts can offer a useful role and I believe that the commission's plans were really quite well thought out in the sense that they were scored, thoughtfully and consistently met the various objectives.

I guess the final thought I want to leave you with is if somebody else has a plan let's see it. We've called many times for other people's plans when they've criticized us and the answer is usually we'll get back to you and they don't. When they do they don't necessarily run it through the stated set of assumptions to make sure it's honestly scored and it really works and so this is a very important consideration going forward. We want to make sure that the proposals that are offered are in fact sensible, that they are scored accurately and that they don't leave you with a big hole, a big black hole of a problem at the end of the window over which they are doing the analysis.

Questions

Q 1.) I just met the old-old definition of 85 and I know that your observations are based on actuarial studies and that governments have an opportunity to mess things up badly. What's happened in Chile and they went on this do it yourself thing some years ago. Have they been successful and how long have they had this privatization?

A 1.) Chile is a fascinating case. I was just there a month ago. I'm starting a research project there. Chile went to a mandatory defined contributions system in 1981, so it's now been more than 20 years. So that's why I think it's right to do an assessment of what's gone well and what's not. Some of the things about the Chilean system I think are really, really brilliant. Very simple, everybody has to contribute ten percent of their pay into these pension fund accounts. You get to choose which account you'd like to invest in and they're competitive. They're somewhat regulated so they don't run off and steal your money.

From the beginning until last year there was only one pension fund option open for you in terms of the actual investment so you could choose which money manager you wanted but they all invested in the same thing so that wasn't very diversified. As of last year each money manager now offers five pension accounts so you can make some decisions within reason about how to diversify. I think that it's a very simple system. It's very attractive. It's experienced something like twelve percent real return annually since the beginning of the system which has made it very popular. There are still some issues in Chile that have come up.

For example, only about sixty percent of the work force contributes. Why? Because if you're self-employed you don't have to contribute. It's still a relatively poor country and so some folks choose not to contribute. So that's a matter of concern. The system is seen as very successful for the middle class and the upper class but the people at the bottom are not necessarily being well helped. On the other hand they're not making any money either so it's hard to get them to contribute to a system when they're barely making ends meet. I think it's a very popular system and that model, the Chilean model, has spread. Something like 24 countries over Latin America have adopted variations on it.

Sweden recently adopted a small personal account program. Germany and Japan are putting one in. So it's sort of like we're at the end of the long list of countries getting around to thinking about this not at the beginning. There have now been twenty years of experience and lots and lots of countries are doing it. The results in Chile have been very good. The results in Mexico have been decent, a lot of the countries I've worked in. Argentina, in all honesty, is sort of a disaster story. They put in a personal account system. They forced everybody to hold government bonds which was a bad model and then they devalued, and so people's accounts were looted as a result of government policy. So it just goes to show you, you can do it well or you could do it poorly. My view is you ought to let people diversify out of government bonds if you have these personal accounts.

Q 2.) What assumptions were used in the model regarding productivity growth?

A 2.) We didn't make up any assumptions, we used the same set of assumptions as the social security actuaries used in all their models. Productivity growth is not bad right now because we're coming out of a recession, right? Over the last 20, 30, 40 years three percent would be wildly optimistic. The social security administration uses something between 1.2 and 1.5 percent. So that's what our assumptions use. Here we're into areas of sensitivity and speculation. As you know, social security always does actually three projections; an intermediate, which is what they think is going to happen, an optimistic, and a pessimistic. A pessimistic assumes things like, we're going to live forever – that's pessimism to social security. We're going to live forever and productivity doesn't grow, and nobody has babies and a whole complex of assumptions.

An optimistic assumption has we're going to die sooner, that's optimism, productivity grows and so forth. So they always try to get a range. We just don't know. So we use what the social security trustees recommend. If you assume productivity growth, that would help some. If you assume people work longer, that would help too. So there are lots of things not directly in our control. The problem is that as a policy analysis you only have certain policy levers. I can't force productivity to grow. I can change the structure of the system. Those are within my range of policy tools. So that's what you have to focus on.

Q 3.) One of the attractive things about these deferred compensation plans and IRAs is they have a contingent beneficiary on there that enables you to give money to individuals that, you know if you and your wife keel over at an early age, or whatever, you can pass along to the kids. I come from a family that we don't stick around the long after retirement and I thought do they have something built into your model too that deals with that issue?

A 3.) There's the issue of pre-retirement and post retirement. In the pre-retirement phase should you die young, prior to your retirement, the money goes to your spouse if you have one or your beneficiaries if you don't have a spouse. Post retirement there's two pieces. We did wish to require that a portion of the money be annuitized so that you could at least keep yourself above poverty in old age. You know if you die and you don't leave anything to your spouse at least you've still kept yourself above poverty when you were alive. If you have additional assets in your personal retirement account those could be bequeathed. That would be the compromise that we've made. Now again you might say why are we forcing anyone to annuitize. Well that gets back to the question of why do we have social security? Why can't you all do it on your own? The sad reality is that people get to old age and they haven't saved anything so this is a way to help them finance their retirement in a way that's a compromise.

Q 4.) Within the last couple years people who are 65 now can grab the benefit out even though they may be earning $200,000 a year. They use to not be able to get that till they were 70 years old. Was that built into the model?

A 4.) I think yes. I think we took whatever was currently in place and a lot of that. Of course when you work after 65 you're still paying social security taxes so you're paying in some and then your benefits get recomputed so it's non-transparent, it's very unclear exactly what's the cost/benefit of working more through the great range of people in the wage distribution. In the terms of Greenspan, Greenspan has been talking about social security for 30 years and from the very beginning. In fact he chaired the 1983 so-called "Greenspan Commission" to raise the retirement age to 67, raise taxes, delay the inflation indexing and so on. So he's a very wise and experienced guy. I'm not quite sure why he said what he did. I think a lot of folks would have wished he'd have said it a little more subtly at the time.

But what I like is the fact that he's putting social security in the current election debate squarely. My sense is that people have been trying to avoid it this year because there are many other obviously priorities on the expenditure side. But my concern is that yes we have a budget deficit this year, maybe for the next two years. Those pale before $12 trillion in unfunded liability that we're not confronting at all. I wish to see it on the public agenda this year and hope and expect our next president, maybe the same one, may not, but our next president will have to focus on it because we still have a few years of opportunity and if we don't do it now then we're going to be in sad shape going forward.

Q 5.) Do you know of any organizations locally that are involved in promoting this issue?

A 5.) There's a group called For Our Grandchildren. This was organized in part through another one of the members of the commission, a woman named Lee Abner. She's done some very interesting work on women in particular and how women end up in some fairly bad straits under the current social security system and how some of these reforms might benefit women quite a bit.

Q 6.) The redefining of old age, does that mean cutting benefits?

A 6.) One of the questions that we dealt with was whether the retirement age should be increased as a way of helping bring the system back into solvency. I think that many people looking at the health capabilities of Americans today believe that raising the retirement age would be a good thing to do, beyond 67, probably to 70. But the reality is that the mobile American retires at 62, not at 65, not at 67. So what happens is as long as we leave 62 as the early retirement age, we can raise the “normal” retirement age according to the formula all you want.

People are still going to retire at 62 but what happens is the benefit they get at 62 is shrinking. As you know for the baby boom generation they can’t get their full retirement benefit at 65 anymore. They have to wait until 67. Nobody said they had to work until 67. They could still go home at 62; it’s just that their benefit will be less. That’s what I worry about. People don’t really realize what’s happening to the early retirement benefit and maybe we ought to be much clearer about it and say look we can not afford in society to let people retire at 62 anymore and lets be clear and raise it to 65. Now the response is that there’s some poor soul who maybe has ailments, injuries, whatever and can’t work anymore.

My response is there are a couple of things they can do. One is there are disability insurance systems. There are private pensions. Those facilitate alternative arrangements. The other is if you’re really in bad shape you can apply for disability insurance. So there are other stop gap measures, or other means of support if you’re really in bad shape and can not work. I think we’re going to have to tell people, I tell my students you’re not coming to school for your first career. You’re not even coming to school to be trained for your second career. You’re going to have 3, 4, 5 careers. You’re going to work until you’re seventy. They all say yeah, yeah, yeah. They don’t believe me.

Q 6.) What happens when you raise the retirement age?

A 6.) Under the current system the benefit formula works in such a way that it all keys up to what they consider the normal retirement age. So lets imagine right now that the normal retirement age is 65. It's actually 65 and a couple of months. So it's at that age you get your "full benefit," a 100 percent of your benefit. If you retire early then you get a reduction. It's called an early retirement reduction. Why? Because you're getting benefits and you're not paying in an extra few years. So what's happening is as they raise the normal retirement age to 67 you can still quit early at 62 but your benefits are depressed so you're only getting 70 percent of your full benefit instead of 80 percent right now. It's a little bit tricky but the basic fact is if you retire early you are getting less money. It's a clear reduction of benefit.

Q 7.) Someone at the Cato Institute has made a proposal about social security that centers around half the payroll taxes being put into a personal retirement account.

A 7.) The question was, I think the proposal was to take one half of your payroll taxes and put them into a personal account whereas our proposal was to take a third of your payroll taxes and put them in. The bottom line is you could do it anyway you want it's just that the more you take out of the current revenue stream to support my mother the more you're going to have to come up with some transition financing to do that. So it's a question of do you think there's transition financing to do that or not. It's feasible, it's just that it's expensive to do that. I'm not objecting to it. You've just got to come up with more money sooner and politicians are always a little bit delicate about that. You want to add to that?

Q 8.) Let's say x percentage of the people go to PRAs put their money in a stock, fund complete and when they retire this cycle is such that the value of their fund is at the poverty level or whatever. Have you built into your model to come in and rescue these people or what happens?

A 8.) It's a good question. So lets say you invested in an asset. Maybe you've been unwise and kept your money 100 percent in stocks all the way up to retirement and the stock market tanks, 25% drop. So what are you going to do? Well you still have the first pillar in social security that will protect you from poverty. So that is very important in looking at the relative appeal of the PRA, the second pillar. The second answer is really getting into the nitty-gritty design. It's quite probable that these PRAs would be designed in such a way that as you get close to retirement that you would be moved more into bonds and out of stock. In fact, that's the way they do it in Chile. As you approach retirement you're not permitted to be a 100 percent in stock because they don't think that's how you should be investing.

So the question is would that be an advisable move and I suspect it probably would be. On the other hand, I would say to you that increasingly when people get into retirement they're not moving 100 percent to bonds. How many people are 100% bonds in this room in terms of their investments? Nobody. How many people are 100 percent in stocks? Two hearty souls. I think the reality is if you're looking ahead to 30 or 40 years to retirement you probably shouldn't be 100 percent in bonds. The relevant question is what's your correct mix? The other thing that came up actually apropos your point is that around the time we were talking about the personal retirement accounts the stock market crashed, Enron, and so forth. Some of the critics were saying you really ought to think about putting some sort of guarantee into these accounts. For those of you who are familiar with finance and insurance you're saying to yourself immediately you can do it but it's going to be expensive.

So the question comes back, what's the nature of the guarantee, who's going to pay for it? All of these things are to be determined. In fact in Germany they required that the personal accounts have a so-called principal guarantee. That is that you always get your money back. Whatever you contributed. You might not get your interest back but at least you get your contributions back. In Japan they do the same thing. So you can do it but you have to think very carefully about not guaranteeing too much because then you end up having problems.

Q 9a.) How much does the map change if you exclude or restrict upper income people from social security benefits? I know my father and many members of his generation were somewhat embarrassed about getting their monthly social security checks but they sure took them. Isn't that a place where benefits can be cut and where people can responsibly take care of their own retirement plans?

A 9a.) A couple of comments about benefits for upper income folks. The first comment I would make is payroll taxes are only levied on earnings up to $87,000. That number is indexed but it covers about 85 percent of the wage distribution. So if you're in the top 15 percent of the earnings distribution you don't pay taxes and you don't get benefits based on that piece.

Q 9b.) I'm self-employed and I pay $16,000 a year on social security...

A 9b.) So that's probably Medicare also? But right now the benefit formula stops at a certain level because your contributions stop so already people in the top 15 percent of the wage distribution are not getting benefits at the margin for additional earnings they make. The second comment I would make is you are also required to pay taxes on your social security benefits if your income is over a certain level. So in fact we already have a form of means testing although politicians don't call it that but it is a form of redistribution. Now you could submit that only 85 percent of your social security benefits are now taxable. You could make it 100 percent. That's not going to be very popular. It would raise a little revenue. It's not going to solve the problem.

A related question is right now we're only levying payroll taxes on people's earnings up to $87,000. So the proposal was let's just lift the cap. That's something a number of the democrats had proposed. The problem is that right now as you raise contributions your benefits go up too, so then you'd be giving more rich people more benefits which is not politically attractive. So it's not a bad idea but we are already doing something. It's not clear how much more you have to go there.