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SOCIAL SECURITY REFORM: A LASTING SOLUTION AND AN UNPRECEDENTED OPPORTUNITY

Over the last ten years or so, our nation has had a vigorous and open discussion concerning the future of Social Security. Many new ideas have been offered, ideas not developed prior to the onset of the debate. The climate of opinion has changed; more Americans are now aware of the issue, and more Americans want the option to leave Social Security and save and invest for their own future. We are getting closer to the point when important decisions will be made, decisions that will affect each of us and the strength of our economy.

But in some respects little has changed politically; many of our elected representatives are still advocating raising taxes and reducing benefits. And nothing has changed legislatively. We have wasted precious time.

A Collision Course

Like other nations we face an unprecedented challenge—how to deal with a reality that mankind has never confronted, and one that most people are unaware of. How we and other governments respond will affect each American citizen, our families, businesses across the land, indeed our very way of life. The reality is not only unprecedented, it is unyielding.

Dr. Karl Otto Pohl, former president of the German central bank, the Bundesbank, stated it this way: "In a relatively short period, we must adapt our domestic institutions, international relationships, and even our individual life plans to a new, and powerful reality."

What he was speaking of, and what confronts each American, is the fact that there are two powerful forces on a collision course. The first is the aging of society, the reality that the elderly population is increasing more rapidly then the population as a whole. In America, but even more so in other countries, the elderly rely on Social Security to survive financially. Should Social Security falter, many elderly will be destitute.

The second force is that most Social Security systems, including ours, are, in fact, faltering. They are financially unstable, and not sustainable as they are presently structured.

The challenge is to avoid the collision of these two forces. By staying the present course, we will not. But should we prevail by structuring a lasting solution, the rewards will be as unprecedented as the challenge itself.

The Early Years: Social Security's Roots

Social Security was enacted in 1935 during the Great Depression. During the first half of the 1930s real GDP fell by about 25 percent, unemployment jumped to 22 percent and the stock market virtually imploded, falling about 70 percent. Our nation was on her economic knees. President Roosevelt had to do something, something big, but large government

programs were anathema to the frontier spirit of our young nation. In order to achieve his goals he needed unprecedented authority. To grasp that authority he went before the nation on March 4, 1933 in his first Inaugural Address and asked for authority "...as great as the power that would be given me if we were in fact invaded by a foreign foe." He achieved his goal and ushered in Social Security, the flagship program of the New Deal.

Much like other Social Security programs that preceded ours, the first being Germany's in 1889, benefits paid to the elderly were financed by payroll taxes. In our case, during the Great Depression, people who had jobs were considered the wealthy. It was unlike today wherein Americans have portfolios of stocks and bonds, real estate, defined benefit and contribution plans and the like; you were considered wealthy if you had a job. And needs were so urgent that the "payroll wealth" was taxed. A saving and investment structure would not have worked at that time because it takes time to compound investment returns to accumulate wealth, and time was short.

Today: A Fundamentally Flawed Program

Over the decades, however, this sort of urgent safety net has turned into the rough equivalent of a defined benefit retirement plan. Yet its financial structure has not advanced. The Old-Age and Survivors Insurance part of Social Security, as its finances are presently structured, is inefficient, financially unsound and fundamentally flawed.

Because benefits are paid by taxing payroll, benefits can increase by no more than payroll increases, assuming that the tax rate on payroll is held constant. Over the last four decades or so, payroll has increased by about 1.5 percent per annum in real terms. That is roughly equivalent to saving and investing and receiving a rate of return of 1.5 percent. To put this into perspective, if one were to save $1,000 each year for a 45-year working career and earn 1.5 percent, the saving would accumulate to about $64,000. If the $1,000 were invested in a portfolio of stocks and bonds, earning returns that our markets have produced on average over the last 80 years or so, instead of $64,000 the accumulated wealth would be about $340,000. These different values give a glimpse of the lost opportunity that most of our citizens incur by being required to finance much of their retirement through payroll taxes.

But it is worse. For any particular age group it matters how many workers pay taxes relative to the number of retirees who receive benefits. This is largely determined by life expectancy and the birth rate, both of which are influenced by the change in national wealth, or GDP per capita. As national wealth rises, nations are better able to afford cleaner air, purer water, vaccinations, more advanced health care and pharmacology, and transportation to and from health care providers—all the things that make it easier for each of us to survive. We observe this not only here but across all parts of the globe. When Social Security was enacted in 1935 life expectancy at birth was 61 years of age; it is now about 78. In the post-war period global life expectancy has increased from 45 to 65 years of age, a greater increase in the last 60 years or so than in the previous 5,000 years. This is all new and it was not expected.

Also, as nations become more wealthy—affording women greater economic choices and personal freedom—birth rates fall. In many countries they have fallen below the population replacement rate of 2.1. The combination of rising life expectancy and falling birth rates causes havoc with our pay-as-you-go financed Social Security system. In 1950 there were 16 workers per beneficiary; today there are 3.3, in 35 years there'll be only two.

In Europe, where governments provide about 80 percent of all retirement income, birth rates have fallen to such low levels that "there is now no longer a single country in Europe where people are having enough children to replace themselves when they die." With the majority of the population so dependent on the state, and the state so dependent on a demographic that does not exist, Dr. Karl Otto Pohl's comments above are more prescient.

The Global Political Response: Raise Taxes

The political responses to the changing demographics that squeeze Social Security's finances are frequently the same across the world. Governments and politicians tend to see the problem in the narrowest of terms: merely a solvency issue—too many benefits paid, too few taxes received. This near-sighted analysis is further compounded by the focus on just today's solvency and not tomorrow's.

But from this myopic perspective the options are clear: raise taxes, cut benefits. Of the two, governments tend toward raising taxes first. This makes sense for at least two reasons. There are more workers to tax than there are retirees from whom to cut benefits. Therefore, if the choice were only one or the other, raising taxes inflicts a lesser per capita burden. The second reason is that workers are younger than retirees, therefore, they have more time to adjust to a tax increase than retirees have to a benefit cut.

We have employed this short-sighted strategy in spades. In 1950 when there were 16 workers per beneficiary, the maximum Social Security tax that year was $90. At that time the tax rate was 3 percent on only $3,000 of wage income. As the glacial force of demographics slowly and unrelentingly squeezed the system, the $90 tax rose and squeezed the worker. Now, the tax just for the retirement portion of Social Security is 10.6 percent of the first $97,500 in wage income, or $10,335. After adjusting for inflation, the tax has increased almost 2,000 percent. In all likelihood, the reason that we stood for this is that the tax increase was so little each year that we never really noticed it. But it is now greater than the income tax for about three quarters of all American workers.

As high as our payroll tax is, European workers would prefer it to what they must endure. In Germany, for example, where the tax is 19.5 percent of payroll just to finance retirement income, a new proposal has been suggested. It is to raise it further to 20 percent in 2020 then 22 percent in 2030 while at the same time reducing benefits and increasing the age when one can receive full benefits. This proposal has not become law but it has been part of their national discourse on how to respond to the challenge of demographic realities within a pay-as-you-go system. We need only gaze across the Atlantic to see what our future holds without fundamental Social Security reform.

Then Cut Benefits

At some point, the strategy of raising taxes approaches a political wall. People sense that maybe, just maybe, they could achieve more with their hard-earned wages than they get from Social Security. Cutting benefits, the lesser desirable strategy, is reluctantly embraced. How to cut them, without making it appear so, has recently become almost comedic in Washington's political discourse.

Fundamental Reform: Retarded by the Claim of Insurance

Eventually, after cutting benefits hits its political wall, the thinking shifts to fundamental reform, saving and investing in wealth-producing assets for all workers. This idea of market-based financing for retirement income is not new, in fact it is old and well established in the private sector, but it is viewed with some disdain from advocates of the status quo. They object to the notion that Social Security be an investment structure and defend their objection by claiming that it is insurance. This claim had some merit decades ago. But not now. In fact, Social Security's finances are in trouble largely because they are based on the insurance model.

Insurance works well when many people are subject to an event that has little chance of happening to any single individual. A good example is homeowners' fire insurance. Many people buy fire insurance to protect their homes and yet few homes burn. Because the number of homes insured is many times the number of homes that burn, the annual insurance premium is very low relative to the replacement cost of one's house. Insurance companies are simply the medium through which

individual uncertainty of loss is transferred to, and financed by, the group.

The insurance model does not work well when the group is subject to an event that the entire group experiences. For example, if it were certain that everybody's house would burn down, say, when the owner reached age 65, then insurance companies would have to charge annual premiums the future value of which would be the cost of rebuilding all the houses. This premium would be a large multiple of the premium charged in the uncertain case. Central to the insurance model is that the ratio of the annual premium to the dollar value of what it protects is negatively correlated to the uncertainty of individual loss.

Social Security is frequently heralded as insurance, more precisely social insurance. The "social" part of the term merely means that the government plays the role of the insurance company. Other than that, it remains the insurance model. When Social Security was enacted in 1935, life expectancy was 61 but benefits weren't payable until age 65. Now benefits are payable at age 62 and life expectancy is 78. The element of uncertainty has flipped upside down. Because of this, the retirement component of Social Security isn't insurance; once one reaches 20 years of age, reaching age 62 or 67 and needing retirement income is almost certain. As a result, there is very little risk, or uncertainty, to transfer to the group.

Under these conditions, social insurance cannot provide such income at a lower cost than saving and investing for retirement. Unfortunately, however, it can and does provide it at a higher cost because it is financed through the payroll tax and is subject to unyielding demographic forces. In a perverse way Social Security's finances, and its adherence to the insurance model are caught in a kind of time warp; in the age of the iPod, Social Security is a 78 RPM wind-up phonograph. Unless protected by the power of the state, it can neither compete nor survive.

The State Monopoly Faces Competition

Being protected by the power of the state really means that for 10.6 percent of their wage income American workers are not free to choose among alternatives for their retirement. Bad as that is, the 10.6 percent doesn't buy much relative to reasonable and available alternatives. This is why Social Security is mandatory; few would participate if they had the freedom not to. Competition is a threat to the status quo. For our fellow citizens principled reform is their hope.

Three Fundamental Principles of Reform

Any reform or competitive system should be guided by three principles that are valued by most civil societies.

- The first is that the elderly should be able to retire with financial security and dignity.
- The second is that younger workers should be able to keep more of the fruits of their labor.
- And the third is that any reform should benefit and not burden the economy.

Part and parcel of these principles is that each American worker should have a choice in how he provides for retirement, and the freedom to make that choice. No one would be required to leave Social Security, but everyone would be allowed to. Their new option would be a market-based alternative.

The New Option: A Market-Based Alternative

The market-based alternative is a saving and investing structure. It replaces taxes with the accumulation of wealth as the source of benefits. Market-based structures are common, time tested, and are becoming even more available around the world as other countries' Social Security systems respond to the same demographic challenges we face.

They are also the retirement program for about 5 million American workers, mainly state and local

government workers who are not in our Social Security system. Other market-based options include 401(k) plans, IRAs, employer sponsored defined benefit plans, and other defined contribution plans. As of year-end 2006, total pension assets in these plans totaled $13.9 trillion, equal to 105 percent of GDP. They are well established.

As common as these structures are, it would still be a significant undertaking to provide a market-based system for all 151 million American workers. Many have low income, are not knowledgeable of our stock and bond markets, and have little investing experience. Beyond this, opponents of reform assert that a national market-based system, based on individual accounts, would be so costly that the benefits of investing would be consumed by fees. These challenges, largely administrative in nature, are reasonable and require a response.

Administrative Challenges Confronting Social Security Reform

Moving to an individual account system is a significant and unprecedented undertaking. To put it into perspective, at year-end 2005 there were about 417 thousand 401(k) plans, and about 47 million individual participants. The individual account system discussed here would be more than three times the size.

Most analyses of administrative costs have approached the issue by looking at what other countries have done and then projecting their costs to the United States. The approach offered here is different. It looks at individual account systems in our country and asks if they can be applied to this challenge of an individual account, market-based system. They can.

An Individual Account, Market-Based System

The objective is to develop an investment and administrative structure that is responsive to many of the reasonable objections leveled against reform. This structure should:

- Create individual accounts with assets owned by the account holder;
- Ensure reasonable costs for all participants, low- as well as high-income workers;
- Minimize employers' administrative burden;
- Provide the opportunity for workers of all incomes to invest in capital markets;
- Ensure that inexperienced investors will not suffer poor returns relative to experienced investors;
- Provide investment choice;
- Offer a solution for workers who make no investment choice;
- Automatically adapt to changing technology and services offered by the financial services industry.

These objectives are important because they have been central in the debate on Social Security reform. They are also integral to the most popular defined contribution system in the United States, the 401(k) plan. Indeed, the 401(k) plan structure is often referenced as a potential model for an individual retirement account plan for Social Security. But even though the 401(k) plan may be a useful model, it cannot be applied precisely because of a record-keeping problem.

The Challenge: The Government's Record-Keeping and Accounting System

The major challenge in creating a 401(k) model of individual accounts linked to Social Security is the timely posting of individuals' savings contributions. This is not possible given the present Social Security record-keeping system. Although the Treasury Department has built a comprehensive system for the collection of FICA taxes from employers, there is no detailed record of individual taxes paid at the time they are collected and sent to Treasury. This information is not communicated to the government until the following year.

Companies remit FICA taxes in lump sums throughout the calendar year, but do not forward to the government at the same time the names of the individual employees who paid those taxes or the

amount each paid. That information isn't provided to the government until the next calendar year when the employer sends W-2 forms to both the government and the employee. Treasury knows throughout the year that a company has paid a sum of FICA taxes for its employees, but the Social Security Administration will not update its records until late June of the following year, and possibly a few months later, with the names of the individual workers who paid those taxes and how much each worker paid. The government never knows when during the year the individual paid the taxes. This recordkeeping process, although workable in Social Security's present structure, is unworkable in a daily environment defined contribution market-based structure. But it is all that currently exists for identifying individual payroll taxes.

The Solution: A Three-Level Approach

The solution is to structure investment options, not all of which require timely and detailed contribution data. This approach involves three investment levels.

At the first level, workers' savings are deducted from payroll and invested in a collective money market fund. Workers own the assets of the fund although the accounting at the individual level is not completed until the following year. This reconciliation is accomplished with the filing of the W-2 form. When the individual's assets are accounted for, units in the money market fund, which include earned interest, are then posted to each worker's account. The fund is dollar priced which means each unit is valued at one dollar.

The units are then invested in one of three balanced funds. Each fund would be highly diversified, investing across multiple asset classes, but with different allocations. Individuals who do not or choose not to make a selection would have their assets invested in a default option.

Each worker has the option after a startup of about four years, a period required to successfully build up assets to achieve economies of scale, to transfer some or all of his balance to an appropriate retail retirement account.

Level One Investment: A Pooled Money Market Account

This pooled account would be a conservative fund similar to a large institutional money market fund. The funds would be held in this pool earning interest for all participants.

Each worker would know during the year how much is invested because it is the same as the year-to-date reduction in the FICA tax that goes to savings, which would be itemized as a separate line item on the pay stub. Interest would always accrue, so the account balance would be in excess of the contribution. All workers, regardless of income, would receive an identical rate of return. Funds would remain in the money market account until the reconciliation of how much each worker contributed, about June to August of the following year.

Level Two Investment: Balanced Funds

When the individual account balance is determined, it is converted to units in one of three balanced funds that the worker chooses. Balanced funds are diversified portfolios that are generally invested in stocks, bonds and cash. The combined assets underlying very successful private employer-sponsored defined benefit plans are essentially balanced funds. One of the Level Two balanced funds may have an allocation that closely approximates these plans. This allows all workers, if they wish, to maintain an asset allocation similar to that provided to the employees of many corporations in the world. There would be another fund on each side of this fund: one for younger workers that would be weighted more toward equities, while the other would be weighted more toward bonds for those closer to retirement.

Although workers could choose their balanced fund, some may not. In this case, they would

default to the middle fund. In other words, a worker— perhaps low income and financially unsophisticated —would be invested in a highly diversified portfolio suited for retirement savings. The portfolios would be managed by professional asset managers chosen through an open and competitive bidding process. Index fund investment management fees most likely would be less than two basis points (bps): two one-hundredths of one percentage point. The balanced funds would be valued daily and prices would be published in the popular press. Workers only need multiply their units by the daily price to monitor their account balance.

Level Three Investment: Rollover Option

After a period of perhaps four years, a period required to successfully build assets in the Level Two account system to realize economies of scale, workers seeking more investment choice would have the option of rolling their investment funds out of Level Two and into any qualified retirement investment account, Level Three.

Those choosing Level Three would transfer assets to a qualified account with a financial services company meeting reasonable and specified standards set by the Trustees. While investors would have a wider range of choice within Level Three, there still would be reasonable investment guidelines. Level Three investment managers would act as the fiduciary for their product offerings and be subject to government oversight. This is consistent with many employer-sponsored plans, both defined contribution and defined benefit.

Level Three might well suit those workers who have a high degree of confidence in a particular money manager, a particular firm or a particular style of investing. It will also serve investors seeking a type of investment unavailable in the Level Two asset allocation funds such as target date retirement funds. An investor, for example, may wish a greater concentration of equity investments than is available in the asset allocation funds. Should a worker find a particular Level Three provider or product unsatisfactory, he could transfer to another Level Three provider or move back to Level Two. This assures competition across Level Three providers as well as competition between Levels Two and Three. This competition structure across providers and between levels will ensure the lowest cost and best service for the entire system.

Record-keeping and Administration

The administration of an individual account system will require the development of a large-scale, customized record-keeping system with the capability to produce a highly efficient service solution. The efficiency of the service application will be dependent upon the design and execution of the system. There is no existing application that meets all the requirements.

The requirements to support a national individual account system will be complex, large-scale and capital intensive. As noted above, this is a challenge of unprecedented scope.

Nonetheless, the application itself is relatively straightforward. Development time can be minimized to allow focus on sizing and scaling the network and building the necessary interfaces to the Social Security Administration (SSA). Unlike mutual fund or 401(k) record-keeping systems, there will not be many unique product features or functions, thus significantly reducing complexity and cost. It is reasonable to assume a system could be developed within 18-24 months to support these requirements.

The greatest challenge in building a record-keeping system to support the requirements of an individual account system is not the complexity of the application, but the need to support the high volume of participant inquiries, transactions, transfers and report generation. To keep costs low, it is critical that most participants utilize voice and Internet technology to obtain information and transact business. The fewer the calls that require a customer service agent the lower the administrative cost.

The volume of calls will be driven by the frequency of transactions and statements, as well as average account size and market volatility. Assuming 151 million accounts and the plan described, participant call volumes may range from 175 million to 350 million annually. In addition, the system will issue 151 million statements, process fund transfers and distributions. This approach assumes the funds are priced daily and accounts updated nightly.

Whether the record keeping is done by a government entity such as the Social Security Administration or out-sourced to the private sector, this task will require the formation of a large service organization to support these requirements. The service firm would need multiple call centers and would need to hire between three and seven thousand employees.

Cost Model

Based on the plan design defined above, a cost model has been developed to project the administration costs under a range of assumptions. The unit cost factors are based on experience in the 401(k) business and have been adjusted in some cases to account for the scale of the individual account option. The requirements of a national system of individual accounts are unique and, therefore, extrapolations from 401(k) experience pose some risks. Unlike the 401(k) structure it is assumed that in a timely fashion the Social Security Administration will provide the individual account recordkeeper an accurate, automated transmission of earnings' histories that will be used to calculate annual contribution data. These and any other expenses associated with reconciling W2 records are to be borne by Social Security. Also, Social Security, at its cost, will maintain accurate and up to date employee address files, as are presently necessary for the annual mailing of the Social Security estimated benefits statements. One's investment account statement could be included in this mailing.

Cost Summary

Based on these design criteria costs as a percent of assets should be about 30 basis points per year or thirty one-hundreds of one percentage point starting in the fourth year. Although costs would be expected to increase annually driven primarily by employee compensation and benefits, assets would increase more rapidly. Costs as a percent of assets, therefore, would fall. These costs are competitive with other investment products and significantly less than average mutual fund costs.

From Costs to Benefits

The benefits of reforming Social Security from a tax-based to a market-based system are significant and numerous. At the individual level, all workers for the first time since the 1930s will have a choice on how to prepare for much of their retirement. Unless they wish to, they would no longer be tethered to the government and its decisions on what they pay for retirement and what they receive. As stated above, no one is forced to leave the Social Security System, but everyone is allowed to.

Second, over time after the full transition to the new system is complete (see below) there will be no payroll tax for retirement, but there will be a mandatory saving of about 5 percent of payroll. This saving is less than the present 10.6 percent payroll tax (Old Age and Survivors Insurance) and will reasonably provide greater retirement income.

Third, unlike Social Security benefits, the accumulated assets are one's personal property. The United States Supreme Court held in a 1960 case, Fleming v. Nestor, that workers have no legally binding contractual rights to their Social Security benefits. This allows the government to change

benefits at its will, and it has. Under the reform explained above, the government would not have that right.

This leads to the fourth point which is that everyone would be allowed to bequeath assets above a certain level to any individual or organization they wish. This is particularly important to low-income workers because they have generally been unable to pass wealth along to their kids. Also, low income workers generally have a shorter life than those with higher income. Therefore, they tend to receive fewer Social Security benefits, making a bad deal even worse for them. Reform would change that; their wealth would not be affected by their shorter life expectancy after retirement.

Fifth, one of Social Security's odd rules is that spousal benefits of divorced couples are not paid unless the marriage lasted for ten years. In contrast, under the reformed system each married spouse would direct half of his total contribution to his spouse's account. If they divorce, irrespective of how long they were married, their account goes with them. Reform is gender neutral, and no one's retirement income is penalized because of divorce.

Under Social Security's present rules a non-working spouse receives one half the benefits of his/her working spouse's benefits. Assume the latter benefits are $2,000 a month. Then the family's benefits, husband and wife combined, are $3,000. When one spouse dies, the family benefits drop to $2,000. Benefits are reduced by one third just because of death. Under the proposed reform benefits are not reduced at all.

Social Security is an age-based system whereas reform is more behavior based. We can't do anything about our age, but we can about our behavior. The market-based structure empowers people. For instance, one can save more while working so that he can receive benefits from his account earlier. For as long as one has enough in his market-based account to provide a stipulated annuity, he can receive benefits at any age he wants. Under Social Security one cannot receive full benefits until age 65-67.

These are just a few examples of how people are treated under the two systems. In every case workers fare better with reform.

Other Important Considerations:

Accrued Benefits

In the beginning, most people who choose the market-based system will have paid some Social Security taxes and earned benefit credits. They will be able to keep some portion of their accrued benefits, and will be issued a zero-coupon government bond that at maturity will approximate those benefits. New entrants to the labor force will be enrolled in the market-based system and, therefore, will not accrue government benefits.

Annuities

Upon retirement everyone will be able to purchase an annuity that guarantees a monthly check for the rest of one's life, sheltering the individual from both market and mortality uncertainties. One could receive additional retirement income with the remaining assets, or leave them to his children, or bequeath them to any person or organization he chooses. All would be free to make these decisions.

Transition

Over time Social Security will provide fewer benefits and our accounts will provide more. The sum of the two will be greater than Social Security's benefits without reform. Eventually, all benefits will be financed by the individual accounts. It will take decades to fully transition to that point. During the interim full Social Security benefits must still be paid to those who are presently retired and those who will soon be retired. Those benefits will be financed by the full payroll tax of those who remain with Social Security and the partial payroll tax of those who choose the new system. These taxes will not be

enough to pay all benefits. This is also true if the system is not reformed. One way, and there are many, of making up the difference, with reform or without it, is to issue debt. Without reform the year that benefits exceed taxes is estimated to be 2017. This mismatch or negative cash flow never ends. With reform the start date is earlier, but there is a limit to the amount of debt that is issued. This is because individuals start to provide for some of their benefits, and in the long run all their benefits. At some point during the transition government benefits become less than the payroll taxes. When this happens debt issuance ends, and the payroll taxes start to pay off the already issued debt.

The long-run steady state is no payroll tax, no government benefits, and mandatory saving within a fully private system.

Final Thoughts

Social Security reform along the lines presented above will increase individual liberty and freedom of choice, reduce the size of the federal government, accumulate more individual wealth and secure personal property rights over that wealth, provide greater retirement income at a lower cost, and save our children and their children from a crushing burden of debt. As desirable as these achievements would be, they will not be fulfilled unless citizens across the country get involved and insist that their representatives in Washington, D.C. pass legislation which not only reforms Social Security, but meets these objectives in doing so. Congress will not reform Social Security unless it determines the risk of not doing so is politically unacceptable.

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