IV. WOMEN AND PENSIONS

Social Security provides a key foundation for retirement security. Pensions and individual savings provide important resources as well. For elderly married couples, these other sources of income account for 64 percent of total income. For elderly unmarried females, these other sources account for 49 percent of total income.

Among Current Retirees, Women Have Much Less Pension Coverage Than Men

- **Women Are Less Likely To Have A Pension.** Only 30 percent of all women aged 65 or older were receiving a pension in 1994 (either worker or survivor benefits), compared to 48 percent of men.[20]

- **Lower Pension Coverage Among Private-Sector Workers.** Only 31 percent of women aged 65 or older (and 55 percent of men) who had worked in the private sector reported pension benefits, compared to 66 percent (and 75 percent of men) of public sector retirees.[21]

- **Pensions Received by Women Are Worth Less than Those Received by Men.** Among new private sector pension annuity recipients in 1993-94, the median annual benefit for women was $4,800, or only half of the median benefit of $9,600 received by men. The median pre-retirement wage replacement rate of annuity benefits was 20 percent for women, compared to 30 percent for men. Among lump sum pension recipients in 1993-94 who were age 40 and over, the median lump sum distribution was $5,000 for women and $14,475 for men.[22]

- **Among Women Approaching Retirement, Pension Wealth Is Much Smaller.** Single women had average pension wealth that was 34 percent of the single men's average. Among married people, the gender gap was even larger, with the women's average being only 25 percent of men's. These estimates include both private and public sector workers with and without pensions.[23]

401(k) Plan Take-up Rates

- **Women Are Less Likely To Take Up 401(k) Option When Offered.** Among private wage and salary workers offered a 401(k) plan in 1993, the overall participation rate was 62 percent for women and 70 percent for men.[24]

- **Lower Take Up Is Largely Explained By Lower Earnings.** The take-up rate is highly correlated with earnings. For example, while only 39 percent of workers earning less than $15,000 per year participate in a 401(k) plan when offered, 90 percent of workers earning $75,000 or more do so. Because men, on average, earn more than women, their overall take-up rates in 401(k) plans are higher. However, when wages are held constant the take-up rate for women is generally equal to or greater than that of men. Among workers earning less than $15,000 in 1993 the take-up rate was 41 percent for women compared to 35 percent for men. For workers earning from $30,000 to $40,000 the take-up rate was 75 percent for women and 72 percent for men.[25]

Among Workers, Women's Pension Coverage Depends on Work Status[26]

- **Overall, Fewer Women Have Pensions Through Work.** For all female workers -- both full time and part time -- 27 million (40 percent) had a pension plan through work in 1997. For all male workers, 34 million (44 percent) had an employment based pension.

- **In Full-time Jobs, Women Are Equally Likely To Have Pension Coverage.** Twenty five years ago, pension coverage for women in full-time jobs was only 70 percent of the rate for men. Today, the coverage rates are nearly identical. In 1997, 50 percent of women in full-time jobs had pension coverage, compared with 49 percent of men.

- **Coverage Is Significantly Lower for Part-time Workers.** Coverage is significantly lower for women who work part time. In 1997, 15 percent of women working part time were covered by pensions versus 50 percent working full time.

- **Women Are More Likely to Work Part-time or Be Out of the Labor Force than Men.** In 1997, 75 percent of men were in the labor force, versus 60 percent of women. In addition, over one fourth of working women were part-time, compared with one tenth of men.

- **Women Who Work Part time Are Less Likely To Work For Firms With Pension Plans.** In 1997, of the 48 million women workers employed full time, 30 million (63 percent) worked for a firm with a plan. Among the 20 million women employed part time in 1997, only 7 million (36 percent) worked for a firm sponsoring a pension plan.

- **Women Who Work Part time Are Less Likely to Participate in Pension Plans.** Among women employed by firms sponsoring pension plans, those employed on a part-time basis are far less likely to participate in the plan, primarily because plans often exclude employees working less than 1,000 hours per year. Of the 30 million full-time women workers in 1997 employed with firms with plans, 24 million (80 percent) participated in the plan. Of the 7 million part-time women workers employed by firms with plans, only 3 million (41 percent) participated in the plan.

- **Vesting Rate is Higher for Women Who Work Full time.** For women participating in a pension plan the vesting rate is higher for those who work full time, particularly for those with less than five years of service. In 1993, 64 percent of women with less than five years of service who were employed full time in private sector jobs reported that they were vested, compared to 56 percent of women employed part time. A total of 325,000 women with less than five-years of pension service in a part-time job reported that they were not vested.[27]

Women Have Smaller Non-Pension Wealth as Well.

- **Median Net Worth Is Lower for Women.** In 1993, the median female householder aged 65 or older had $9,560 in financial net worth (not including equity in own home). In comparison, the median male householder had $12,927, and the median married couple had $44,410.[28]

V. Conclusion

As discussions of Social Security reform continue, it will be important to study the impacts of comprehensive reform proposals on women. The design of reforms must take into account, not only the current characteristics of elderly women, but also the changes in their needs that are likely to come about in the 21st century as more women with long work histories reach retirement. In addition, reforms should consider the entire range of sources of retirement income available to women and how Social Security can best fit into the overall retirement security package.

ENDNOTES

1. Social Security Administration, Office of Policy, October 1998.

2. Bureau of the Census, *Poverty in the United States: 1997,* September 1998.

3. Social Security Administration, Office of Policy, October 1998.

4. Social Security Administration, Office of Policy, October 1998.

5. Social Security Administration, Office of Policy, October 1998.

6. Social Security Administration, Office of the Chief Actuary, October 1998.

7. Social Security Administration, Office of Policy, October 1998.

8. These calculations make the assumption that other income would not change if Social Security were not available.

9. Social Security Administration, Office of the Chief Actuary.

10. Bureau of Labor Statistics, Current Population Survey, October 1998.

11. Social Security Administration, Office of Policy, October 1998.

12. Social Security Administration, Office of the Chief Actuary, October 1998.

13. Social Security Administration, Office of the Chief Actuary.

14. The average benefit based on women's own earnings is the average for only those women claiming benefits as retired workers. Thus, it does not include the 37.5 percent of aged female beneficiaries who receive benefits as wives or widows only. Including these additional beneficiaries with full "worker" benefits of zero in the average would reduce the average full benefit for women as a share of the average full benefit for men to 39 percent.

15. Social Security Administration, Office of the Actuary.

16. The average benefit for retired female workers based on their own earnings records is calculated using only those women claiming benefits as retired workers. In the future, increased labor market experience will be divided between increased years of work for women who already have been receiving retired worker benefits, and additional women becoming eligible for worker benefits. As more women claim benefits as retired workers, many of the additional women will have earnings below the average for women already claiming as retired workers. This expansion of the population used in calculating the average explains in part why the average is forecast to rise only from 62 to 67 percent of the average for men even as cohorts of women retire with much greater labor market experience.

17. Social Security Administration, Office of the Actuary.

18. The subsequent estimates are based on integrating evidence from a number of studies, including the following: Hurd, Michael D. (1990). "Research on the Elderly: Economic Status, Retirement, and Consumption Savings," *Journal of Economic Literature*, XXVIII(2): 565-637. Holden, Karen (forthcoming). "Insuring Against the Consequences of Widowhood in a Reformed Social Security System," In National Academy of Social Insurance, *Framing the Social Security Debate: Values, Politics, and Economics*, Brookings Institute. Holden, Karen C., Richard V. Burkhauser, and Daniel A. Myers (1986). "Income Transitions at Older Stages of Life: The Dynamics of Poverty," *The Gerontologist*, 26(3): 292-297.

19. Holden, Karen (forthcoming). "Insuring Against the Consequences of Widowhood in a Reformed Social Security System," In National Academy of Social Insurance, *Framing the Social Security Debate: Values, Politics, and Economics*, Brookings Institution. Holden, Karen C., Richard V. Burkhauser, and Daniel A. Myers (1986). "Income Transitions at Older Stages of Life: The Dynamics of Poverty," *The Gerontologist*, 26(3): 292-297.

20. Department of Labor, Current Population Survey, September 1994.

21. Department of Labor, Current Population Survey, September 1994.

22. Department of Labor, Current Population Survey, September 1994.

23. Gustman, Alan, Olivia Mitchell, Andrew Samwick, and Tom Steinmeier. Forthcoming. "Pension and Social Security Wealth in the Health and Retirement Study." *Wealth, Work, and Health: Innovations in Measurement in the Social Sciences*, editors, James P. Smith and Robert Willis. Ann Arbor, Michigan: University of Michigan Press.

24. Department of Labor, Current Population Survey, April 1993.

25. Department of Labor, Current Population Survey, April 1993.

26. Unless otherwise noted, data in this section are from the Department of Labor, Current Population Survey, March 1998.

27. Department of Labor, Current Population Survey, April 1993.

28. Bureau of the Census, *Asset Ownership of Households: 1993*, August 1995.

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Divider Title: **15**

SOCIAL SECURI' 'Y AN) MINORITIES

- **<u>Social Security is particularly important for minorities</u>.** Social Security is the only source of income for 33 percent of elderly Hispanic Americans, 33 percent of elderly African Americans, and 16 percent of elderly white Americans.

- **<u>Social Security combats poverty among elderly minorities.</u>** Without Social Security benefits, 61 percent of elderly Hispanic Americans and 62 percent of elderly African Americans would be in poverty (compared with 49 percent of elderly white Americans).

- **<u>The survivors insurance program is particularly significant for African Americans because they are more likely to die before the retirement age.</u>** African-Americans make up approximately 12 percent of the American population, but 23 percent of surviving children being paid by Social Security.

- **<u>African American families are more likely to receive benefits from the disability program.</u>** In 1995, 12 percent of the population was African American, however, 18 percent of disabled workers award benefits were African American.

RATES OF RETURN FOR <u>AFRICAN AMERICANS</u>:

- Average incomes for African Americans are lower than for whites. Thus African-Americans receive a higher than average rate of return on Social Security (because the benefit formula is progressive). This is somewhat offset by lower life-expectancies: life expectancy at age 65 is two years less for blacks than for whites.

- **<u>However, a 1993 Treasury study shows that on net, African Americans have a slightly higher rate of return on Social Security than whites</u>**. African Americans also fare relatively better under the DI program than whites.

RATES OF RETURN FOR <u>HISPANICS</u>:

- **<u>Hispanic Americans do better on average than other Americans within Social Security</u>**. Hispanic Americans, on average, have higher life expectancies and lower incomes than other Americans -- both of which boost their rate of return on Social Security.

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Divider Title: **16**

BACKGROUND ON RETIREMENT INCOME AND PENSIONS

RETIREMENT INCOME:

- The vast majority of Americans depend on Social Security for much of their retirement income.

  -- Social Security benefits represent the majority of income for two-thirds of elderly beneficiaries, and are the *only* source of income for 18 percent of its elderly beneficiaries.

- However, Social Security is only one leg of the "three-legged stool" of retirement income. Private pensions and personal savings are a necessary components of a secure retirement income.

  -- Currently, Social Security replaces just one-half of pre-retirement income for an individual who earned $15,000 a year. It replaces less than one-quarter of the income of an individual who earned $68,000 a year.

  -- Social Security is virtually the only source of income for individuals in the lowest two income quartiles of Americans. Individuals in the highest income quartile rely on other sources of income (pensions, savings, wages) as much as on Social Security income to meet their financial needs in retirement.

SOURCES OF INCOME FOR PERSONS AGES 65 AND OLDER

Source of Income	Percentage of Total Income
Social Security	40.3
Earnings	20.0
Private and government employee pensions	18.0
Income from Assets (including savings)	18.0
Other	3.7

- Less than half of all individual aged 65 and older received a private pension in 1994.

Pensions:

- **Despite the large increase in workers covered by defined contribution (DC) plans, half of all American workers are not covered by a pension plan**

  -- The number of defined contribution (DC) plans more than tripled, from 208,000 in 1975 to an estimated 647,000 in 1997, and the number of participants almost quadrupled, from 12 million to 46 million. (The number of workers in defined benefit plans has remained constant, while the number of DB plans have fallen in part because many small businesses have discontinued their plans.)

  -- Nonetheless, half of all American workers, more than 50 million, are not covered by a pension plan.

  -- Only 21 percent of private sector workers earning under $15,000 per year have pension coverage, as opposed to 81 percent of workers earning $50,000 or more per year.

  -- Only 24 percent of full-time workers in firms with fewer than 100 employees have pension coverage, as opposed to 68 percent of full-time workers in firms with 100 or more employees.

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Divider Title: **17**

INDIVIDUAL ACCOUNTS

FRAMEWORK FOR ANSWERS:

- **The President Has Said That He Will Examine Any Proposal in the Context of a Comprehensive Reform to See if it is Consistent With His Five Principles.** As part of an overall plan, many ideas are on the table. Ultimately, what we must consider is whether a comprehensive reform package meets his principles. That's why we don't want to judge any specific element now.

- **At the Kansas City Forum, the President Said That He Will Consider Whether Some Form of Individual Accounts Can Be Part of a Comprehensive Reform That Meets His Principles.** We especially need to consider whether a Social Security system including Individual Accounts continues to provide a benefit that can be counted on and whether the system continues to be fair and progressive.

- **At This Stage in the Debate, We Want to Stay Open Minded and Give Every Option a Fair Hearing.**

KEY ADDITIONAL POINTS:

- **Higher Returns Come with Higher Risk.** Most people have been discussing ways to get higher returns for the Social Security system. Individual accounts could allow a higher rate of return than Social Security currently offers. And individual accounts could also allow every American more control over their retirement assets and give every American a greater stake in the economy. But we must be straight with the American people and acknowledge that with greater returns comes greater risk.

- **Administrative Costs and Government Involvement in the Stock Market Are Major Issues.** It's clear that if these costs are not kept low, they could take a significant chunk of potential returns. On the other hand, those who point out that trust fund equity investments can be done with lower costs need to recognize that some people have concerns about government involvement in the stock market.

- **Cannot Forget about Transition Costs.** Everyone is going to have to be clear about how benefits for people entitled to benefits under the existing system are going to be paid for.

BACKGROUND:

- **Advantages of Individual Accounts:**

  - *Higher Returns.* Individual accounts could allow a higher rate of return than Social Security currently offers. The "equity premium" -- the difference between the average annual rate of return earned by the S&P 500 and the rate earned by bonds -- has averaged 3.84 percent over the past four decades. Many economists are concerned, though, whether this gap will persist into the future.

  - *Greater Sense of Control.* Individual accounts also could allow a greater sense of control over your retirement income.

- **Disadvantages of Individual Accounts:**
  - *Risk Borne By Individual.* Individual accounts would force individuals to bear more of the risk for their retirement income.
  - *Administrative Costs.* Individual accounts would involve high administrative costs, especially compared to investing the Trust Fund in the stock market or the current Social Security system (administrative costs equal only 0.8% of contributions per year). Administrative costs can have a large impact on retirement income: for example, annual administrative costs of 100 basis points would mean 21% less retirement income for a retiree. <u>Peter Diamond has found that in the United Kingdom total administrative costs in the typical retirement account *reduce* retirement income by more than 24%</u>.
  - *Transition Costs Could Be Significant.* Some forms of individual accounts involve significant transition costs because moving from a pay-as-you-go system to some forms of individual accounts could force one generation to pay twice (once for their parents, and once for their individual accounts), or many generations to share those costs.

BACKGROUND ON INDIVIDUAL ACCOUNTS

KEY ISSUES WITH ADD-ON INDIVIDUAL ACCOUNTS FUNDED BY THE SURPLUS:

KEY ISSUE #1: LONG-RUN BUDGET VIABILITY

- Add-on Individual Accounts cannot be funded out of the surplus forever. For example, $500 per worker can be afforded -- as part of a comprehensive reform -- until between 2012 and 2057 depending on which surplus forecast is used (and assuming that surpluses not spent on Individual Accounts after 2008 are used to pay off debt). During the next decade, an add-on Individual Account with contributions of $500 per worker would require 37 percent of the surplus. Over the next 35 years, the funding of these Individual Accounts would represent 0.7 percent of GDP.

- Two percent of payroll Individual Accounts can be funded between 2011 and 2051 depending on which surplus forecast is used. During the next decade, they require 42 percent of the surplus.

- Because these Individual Accounts are dependent on projected surpluses, they create the following future budget scenarios: (1) the perputual commitment to $500 per worker per year will create future fiscal deficits and put pressure to unduly cut back government programs in the outyears -- which may hurt support for this proposal today; (2) may need to seek trigger or other mechanism to ensure that Individual Account funds do not lead to future budget deficits; and (3) could put pressure to use remaining surplus in early years for debt reduction.

- Individual Accounts could also create a "slippery slope" toward privatization if stock market performance was particularly impressive in the near future.

- Contribution to Individual Account does not have to be $500 per worker per year. Lowering the contribution -- to say, $250 -- would mitigate some of these factors.

KEY ISSUE #2: PRESERVATION OF TRADITIONAL SOCIAL SECURITY BENEFIT

- Protects the 12.4 percent payroll tax for the traditional Social Security system. This approach to individual accounts has the most potential to attract defenders of the traditional system.

- Because the approach brings additional revenue into the system, it reduces the need for overall benefit cuts -- when both the retirement income from individual accounts and traditional benefit are taken into account -- and will appeal to people who favor pre-funding of Social Security's obligations.

- These Individual Accounts could be described as a tax cut.

- Because the benefits from an Individual Account are uncertain, some will argue that the income from the Individual Account should not be counted -- which would show significant benefit cuts.

KEY ISSUE #3: RISK

- Risks of stock market variation and bad investment choices would fall on individuals on the portion of benefits coming from Individual Accounts. Additional "appearance risk" results when people expect the final account value will match its highest level over its lifetime.

- However, the risk in Individual Accounts depends to a certain extent on how they are designed. For example, a "safe investment option" could be provided through inflation-protected Treasury bonds. A minimum benefit or other guarantee could minimize the downside risk of the overall system.

- One possible goal for reform would be to try to design a package in which the traditional benefit plus the individual account totaled as much as current law benefits, if the individual invested in the safe investment option. This would be the default option; those workers who wanted to take on more risk to seek a higher return would be allowed to do so.

KEY ISSUE #4: PROGESSIVITY

- Flat contributions lead to higher benefit levels (as a fraction of current law benefits) for lower-income workers. On the other hand, percent of payroll individual accounts plans do the most for high-income workers.

	Social Security benefit plus annuity from $500/worker individual account (as percentage of current law benefit)	**Social Security benefit plus annuity from 2 percent individual account** (as percentage of current law benefit)
Low Earner	116.1	101.5
Average Earner	104.0	106.9
High Earner	99.4	111.5

KEY ISSUES WITH CARVE-OUT INDIVIDUAL ACCOUNTS:

KEY ISSUE #1: THE TRANSITION PROBLEM

- When two percent is carved out for Individual Accounts, that revenue can no longer pay for benefits for current retirees. This approach would take $700-$900 billion from the traditional Social Security system over the next 10 years.
- This dilemma -- the "transition problem" -- in moving from a pay-as-you-go system to a funded system is that if the contributions of current workers go into Individual Accounts for their retirements, how do we pay for the retirement of current retirees?
- The unified budget surplus could be transferred to the trust fund and used to pay for benefits under the traditional Social Security system during the transition period. Under the most optimistic long-run budget projections, transfering the *entire* surplus to the trust fund would cover the entire 2.19 percent shortfall <u>plus</u> half of the lost revenue from the carve-out.
- In 40 years, when workers will have contributed to Individual Accounts for their entire working lives, traditional Social Security benefits can be reduced and still leave total retirement income above current law benefits.
- In the short run, though, benefits need to be cut to make up for the lost revenue and for 2.19 actuarial imbalance, but the Individual Account will not be large enough to offset these cuts.
- An important challenge in designing reform plans is to time the benefit cuts and the build up of Individual Accounts so that the total benefits of retirees over the transition do not fall too much.

KEY ISSUE #2: POLITICAL VIABILITY

- A number of the reform plans proposed by moderate Members of Congress take the approach of carve-out Individual Accounts.
- Can be described as a promising new social compact: workers get a payroll tax cut so long as they save it in their Individual Accounts.
- Can use surplus to partially mitigate transition costs.

KEY ISSUE #3: LONG-TERM STRUCTURE OF PROGRAM

- For the average retiree in 2030, the income from an add-on Individual Accounts would account for 18 percent of their retirement income. For a similar retiree, a carve-out Individual Account would be 24 percent of their retirement income. These numbers are even greater for beneficiaries eligible for Social Security in 2050: the add-on Individual Account would be 29 percent and the carve-out would be 38 percent.

- Individual Accounts could be accompanied by a guaranteed benefit or a guaranteed return which would both reduce individual risk (but at a price).

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Divider Title: **18**

INVESTING TRUST FUND IN EQUITIES

FRAMEWORK FOR ANSWERS:

- **We Know That Finding A Way To Raise The Rate of Return of Social Security Is A Key Issue And Investing the Trust Fund in Equities Is One Proposal Advanced By Many Experts.**

- **Those Who Favor this Option Say That it Is a Good Way to Get Higher Returns with Low Administrative Costs.** Proponents argue that by investing the trust fund in equities, Social Security could receive the high stock market rate of return without the administrative expense of setting up millions of individual accounts. In addition, investment risk would be pooled across *all* Americans.

- **Others Are Concerned about the Government Owning Stock in Private Companies.** Opponents argue that at best this could lead to difficult corporate governance issues (such as how stock proxies would be voted), and at worst, could lead to dangerous political interference because of the temptation for the government to invest in certain industries, certain states, or not to invest in politically unpopular companies.

KEY ADDITIONAL FACTS:

- **Experts Are Split on Investing in Equities.** Experts such as Henry Aaron, Robert Ball, and Robert Reischauer have advocated this approach. Alan Greenspan is opposed to this approach, saying in Congressional testimony that he found it "very dangerous" and that it would have "very far-reaching potential dangers for the free American economy and a free American society."

- **Administrative Costs Are an Important Issue for Social Security Reform.** The current Social Security system has low administrative costs, only 0.8 percent of benefits paid. There would likely be additional administrative costs in a system that invested the trust fund, but not nearly as much as in a system of individual accounts. However, some argue that an inexpensive individual account system is possible -- modeled after the Federal Thrift Savings Plan (TSP) -- providing lower administrative costs with fewer attractive services.

- **Even Ownership of a Small Fraction of the Market by the Trust Fund, Could Raise Issues of the Government Owning Large Fractions of Individual Corporations.** This approach could potentially lead to the government as the "single largest shareholder in 200 of the 500 largest American companies."

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Divider Title: **19**

BACKGROUND ON RISK

KEY POINT #1: THE CASE FOR EQUITIES

- Stocks have out-performed bonds over nearly all long periods of time in the US during the past century.

  -- The "equity premium" is the difference between the average annual rate of return earned by stocks and the rate earned by bonds. The table below shows this difference in returns between the S&P 500 and the bonds held by the Social Security trust fund for various time periods.

- During the 20th century in the US, even large stock market declines have been more than made up for in subsequent rebounds.

  -- A portfolio of a worker who lived through the 1929 crash -- when the S&P 500 lost 85 percent of its value between September 1929 and June 1932 -- would have fully recovered by the end of 1936.

Equity Premium
S&P 500 over Social Security Trust Fund Bonds
(percent per year)

		End Year					
		1949	**1959**	**1969**	**1979**	**1989**	**1996**
Start Year	**1939**	6.91	11.63	9.16	6.69	6.65	6.51
	1949		16.56	10.30	6.61	6.58	6.42
	1959			4.37	1.96	3.45	***3.84***
	1969				-0.39	3.00	3.64
	1979					6.50	6.09
	1989						5.52

KEY POINT #2: CAUTIONS ABOUT EQUITIES

- **Markets fall.** While 20th century US markets have always rebounded strongly from large market declines, this need not be the case in the future.
  - On three occasions during the past 70 years, the S&P 500 index has declined over two years by more than 35 percent (in nominal terms).
  - Japan's Nikkei index has fallen by 60 percent since 1989.
  - The S&P 500 (even including reinvested dividends) did not regain its 1968 value in real terms until 1983.

- **Perceptions may be colored by recent stock market history.** The tremendous recent stock market performance has likely increased support for investing Social Security funds in equities. If the stock market were performing badly, as it did in the 1970s, it is unlikely that people would be as eager to invest Social Security funds in the market. Indeed, in 1979, *Business Week* ran a cover story entitled "The Death of Equities."

- **Stocks may not retain their historic advantage relative to bonds.** Simple economic models have trouble explaining why the 20th century rate of return on stocks has been so much higher than the return on bonds. Many economists think that the added risk from stocks is not sufficient to justify such a large "equity premium." Given that it is not well understood why stocks have out-performed bonds in the past, some economists are concerned about whether this gap will persist into the future.

- **Shorter market exposure at beginning of new system.** In the transition to a new individual account system, older workers would participate in the system for only a few years before they reached retirement. These workers would not have a full 40 years of market exposure. If a downturn occurred during their few years of contributions, the older workers could end up doing worse than in safer investments.

- **Lack of individual or political patience after downturn.** In a system of Individual Accounts, individuals might shift out of equities after a market decline, missing the recovery. If the trust fund were invested in equities, there might not be sufficient political patience to stay with an equity-based system after a large market downturn. If equity investments were abandoned after the first large downturn, such a system could provide the worst of both systems, the low returns of bonds plus the risk of equities.

- **Perceptions of pre-retirement market declines.** Individuals might feel that they had fared poorly even if they had done better over their lifetime being invested in equities than in government bonds. For example, if the market fell substantially just before a worker retired and annuitized his/her account, he/she might feel that it was unfair that workers who had retired one year earlier received higher retirement incomes. Similarly, if a worker annuitized his/her account balance at a point when the stock market is below a previous peak, the worker might feel like he/she lost even though he/she did better over his/her lifetime.

- **Naïve investor risk.** Some individuals might lack the investment know-how to make wise investment decisions. This risk could be largely eliminated by constraining the investment options available to individuals.

KEY POINT #3: RISK UNDER DIFFERENT REFORM PROPOSALS

- **Risk in the current Social Security system.** The current system does not have market risk. However, it has other forms of risk:

  -- Political risk that tax or benefit rules will change. For example, Social Security taxes and benefits have changed numerous times in the past 60 years.

  -- Demographic risk that forecasts of mortality and fertility trends will turn out to be incorrect. For example, if projected fertility rates dropped by 0.3 children per woman, the actuarial imbalance would worsen by about 0.4 percent of payroll.

  -- Economic risk that productivity growth will be higher or lower than currently forecast. For example, if productivity growth fell by 0.5 percentage points, the actuarial imbalance would worsen by about 0.55 percent of payroll.

- **In reforms, only a portion of benefits would be exposed to market risk.** Even in 2070, payroll tax revenue will be sufficient to provide two-thirds of current-law Social Security benefits. If the full payroll tax continues to be dedicated to providing the traditional benefit, then at most one-third of the total Social Security benefit would be at risk.

  -- If only a limited portion of the trust fund -- for example, 25 percent -- were invested in equities, less than 15 percent of benefits would be dependent on stock market performance.

  -- Individual accounts funded with contributions equal to $500 per capita or 2 percent of payroll would typically provide less than 37 percent of total Social Security benefits including IA account proceeds (assuming the accounts were invested half in bonds and half in stocks). Thus, over 60 percent of benefits would be free of market risk.

- **By investing through the Social Security trust fund, some risks are reduced.** With the trust fund partially invested in equities, there would be no need to tie annual benefits to year to year trust fund performance. Thus, market risk could be spread both across workers and across generations. In addition, since individual workers would not be making investment decisions, there would be no "naïve investor" risk.

KEY POINT #4: VARIATION IN RETIREMENT INCOME FROM MARKET EXPOSURE

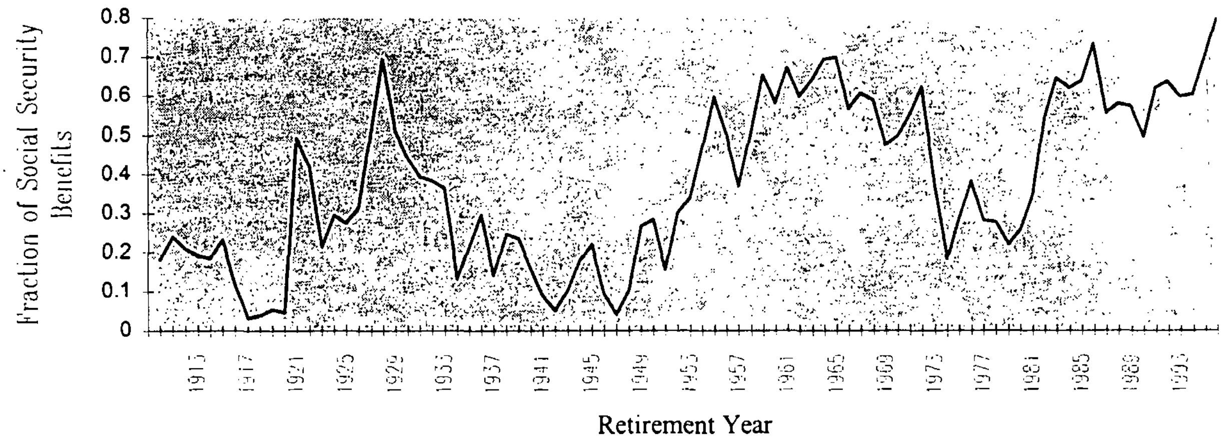
- **<u>Outcomes from market investments depend on when individual retires</u>.** Studies suggest that individuals would have widely different outcomes from market investments solely because of the market performance in the particular years in which they lived. For example, average workers retiring in 1972 would have received a retirement annuity equal to more than 60 percent of their current-law Social Security benefits. However, individuals retiring two years later, in 1974, would have received an annuity that was only 20 percent of their current law benefits.

- **<u>In past century, Individual Accounts could have provided between 5 and 80 percent of an average worker's current law Social Security benefits</u>.** If average workers had had a 2 percent Individual Account and retired a different times in the past century, their retirement annuities would have varied greatly: from 5 percent to 80 percent of their current law Social Security benefits.

- **<u>In most years, Individual Accounts could have provided a large enough annuity to ensure that current benefits were maintained</u>.** One constructive way to view this result is that under the illustrative plans we discussed last week, the traditional Social Security program would continue to provide an additional 66 to 85 percent of current-law benefits (depending on whether the Individual Accounts were implemented as carve-outs or add-ons). Thus, to maintain current benefits, the annuity from the Individual Account would have to be at least 15 to 34 percent of current benefits, depending on whether it were an add-on or carve-out Individual Account.

- **<u>There are a number of limitations to this analysis.</u>** The chart assumes that the entire individual account was invested in the S&P 500, and was annuitized at the Aaa corporate bond rate in the year that the worker turned 65. If a portion of the accounts were invested in bonds, or if annuitization happened in stages, the variation in experiences would be reduced.

Fraction of Social Security benefits replaced by 2% Individual Accounts



KEY POINT #5: WEALTH CREATION

Supporters of Individual Accounts make strong arguments about how such accounts help to create wealth and give lower-income workers a stake in the economy. Advocates base their argument on four ideas:

1. **<u>Access to Higher Rates of Return.</u>** Because nearly half of all Americans have little or no financial assets, Individual Accounts would give lower-income workers access to the higher rates of return offered by the stock market, and allow them to build wealth for their retirement.

2. **<u>Allows Individuals To Use Income However They Want</u>.** Many Individual Account proposals would require retirees who have accumulated a large nest-egg to annuitize enough of the account to provide a basic retirement income, while allowing the retiree to take the remaining money in a lump-sum to be spent as they wish. In other words, retirees would have to set aside a minimum amount of money, but the rest could be used for whatever they desire.

3. **<u>Individual Accounts Could Be Bequeathable</u>.** Some people die before they reach age 65, and Individual Accounts could be bequeathable, thus making it possible for individuals who do not pass along any wealth to their heirs to do so. However, if a portion of individual accounts were bequeathable, the income available for consumption during retirement years would be reduced.

   -- Most reform proposal retain the existing structure for survivor benefits for young people. However, cuts to the Social Security benefit formula -- as part of comprehensive reform -- would reduce survivor benefits.

   -- Permitting bequests is particularly appealing to low-income and minority populations which have lower life-expectancy, and therefore, on average, would not receive their Individual Account annuity for as many years. For example, life expectancy at age 65 is 1.8 years shorter for blacks than for whites. (In the traditional Social Security system, the progressivity of benefit formulas offsets the shorter life expectancy.)

4. **<u>May Change Perception of Saving</u>.** The experience of owning an Individual Account may lead people who do not save currently to begin saving on their own. By directly showing people the power of compound interest and the benefits of savings, we may alter people's spending habits.

KEY POINT #6: TRANSITION COSTS AND MISLEADING RATES OF RETURN ARGUMENTS

THE CHARGE:

- **Some claim they could do better investing on their own.** Many critics of Social Security point to the rate of return that workers will earn in the future on their contributions into the system, and argue that they could do better on their own investing in individual accounts.

  -- According to the Social Security actuaries, a single male with average earnings retiring in 2030 will receive a real return of only about 1-1/2 percent per year.

  -- By contrast, over the period 1926-1996, stocks earned a real rate of return equal to about 7 percent per year.

- By using the surplus to prefund retirement benefits and invest in equities, it is possible to increase rates of return in the future.

THE TRANSITION ISSUE:

- The story is different if we are talking about funding individual accounts with revenue currently allocated to paying benefits under the current system. In this case, simply calculating rates of return for the individual accounts ignores the need to provide benefits for current and future retirees who have paid into the current Social Security system.

- Ninety percent of contributions into the Social Security system are used immediately to pay benefits to today's retirees and other beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirement, we will need to come up with some other way to pay retirement benefits for people who are entitled to Social Security benefits.

- Rates of return that ignore this cost are misleading when compared to Social Security rates of return that include this cost.

IS THE RATE OF RETURN THE CORRECT WAY TO JUDGE SOCIAL SECURITY?

- Some suggest that focusing too much on rate of return does not acknowledge that Social Security plays a distinct role as a universal low risk leg in the retirement structure that you can always count on.

REAL RATE OF RETURN TO SOCIAL SECURITY CONTRIBUTIONS (Percent per year)						
Year born/ year age 65	**Single male earner**			**One-earner couple**		
	Low earnings	Avg. earnings	High earnings	Low earnings	Avg. earnings	High earnings
1920/1985	4.4	2.8	2.5	8.1	6.6	6.3
1930/1995	3.1	1.9	1.5	6.1	5.0	4.7
1964/2029	2.4	1.3	0.7	4.7	3.7	3.1
2004/2069	1.5	0.8	0.2	4.0	3.0	2.4

KEY POINT #8: OPTIONAL INVESTMENTS IN INDIVIDUAL ACCOUNTS

Some reform proposals include a voluntary individual account option. These options are of two types:

TYPE I: Individual Account proposals that allow additional contributions

TYPE II: Non-Individual account proposals that would allow for a Voluntary individual account

ISSUES:

- A main benefit of these proposals is that for the half of all American workers who do not have pension plans this could be a major step toward increasing employment-related retirement savings.

- Some employers who currently resist the administrative burden of setting up retirement programs might match employee contributions, thereby augmenting the impact of the worker's savings.

- However, it is possible that some employers who currently provide a pension to their employees might cancel these plans knowing that their employees have this new retirement savings option.

- In addition, since most employees currently have the option of contributing to an IRA, the new accounts might not be seen as providing much additional impetus for saving.

- Indeed, the plans could be criticized for giving upper-income Americans another opportunity for tax-preferred saving. This risk could be minimized by providing a cap on total contributions to IRAs, 401ks, and the new Individual Accounts.

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Divider Title: **20**

ADMINISTRATIVE COSTS

KEY POINT #1: INTERNATIONAL EVIDENCE ON ADMINISTRATIVE COSTS IN INDIVIDUAL ACCOUNT PLANS

- **Administrative costs in Chile have been high.** The accumulation of administrative costs over a worker's career results in retirement income in the Chilean system that is 20 percent lower than it would be if there were no administrative costs.

- **In Chile, fund management companies appear to compete on factors other than price.** The funds are highly regulated in the types of allowable investments, and offer very similar portfolios. Individuals are allowed to switch portfolios every 4 months. This has caused fierce competition. The funds spend huge amounts on advertising, have increased their sales forces, and offer incentives such as televisions or trips to lure individuals to their particular fund. This non-price competition has driven up costs.

  -- In Chile there are 3.5 salespeople per 1,000 contributors. In the United States, there are 0.5 SSA employees per 1,000 insured workers.

- **Costs in the early years of the UK individual account system have been high as well.** In the UK, workers can opt out of the earnings-related defined benefit system, and instead contribute to an individual retirement account. A recent paper by Professor Peter Diamond reports that the charges for these individual accounts are large, complicated, and often not visible to the workers. He calculates that the total administrative costs in the typical UK account reduce retirement income by more than 24 percent.

- **The international evidence suggests that it is important to focus on ways to keep costs down.** The lesson from these two examples is <u>not</u> that individual account systems are necessarily expensive, but rather that it is important to design systems in a way that provides the desired services at a reasonable cost.

KEY POINT #2: ADMINISTRATIVE COSTS DEPEND ON SERVICES PROVIDED

- **Administrative costs can have a large impact on retirement income.**

Annual Administrative Costs (basis points per year)	Percentage Reduction in Value of Individual's Retirement Income
10	2.4
50	11.5
100	21.5

- **Current US system has very low costs.** The current Social Security system has maintained an extremely low level of administrative costs. Less than 1 cent of every dollar paid into the system by workers and employers goes to administrative costs. To achieve this low an administrative cost, an individual account plan would have to have annual administrative costs of less than 5 basis points.

- **Investing trust fund in equities would be extremely inexpensive.** Estimates suggest that costs could be only one-half of one basis point.

- **Under individual accounts, costs could vary widely depending on the services provided and on the way in which the accounts are administered.**

Estimated Administrative and
Investment-Management Costs for Individual Accounts
(bps = basis points)

Administering Body	Passive Mutual Fund	Active Mutual Fund
Government-Based (e.g., TSP)	8-16 bps	58-66 bps
Employer-Based (2,000 workers)	36-44 bps	109-117 bps
Employer-Based (25 workers)	76-86 bps	138-148 bps
Individual-Based (e.g., IRA)	81-91 bps	143-153 bps

- **Costs in the early years would be even higher.** Account balances would be small at the beginning, driving up cost ratios.

- **The costs of actively managed funds are significantly higher than are the costs of index funds.** A 1998 Department of Labor study found average expense ratios for actively managed retail large equity funds of 147 basis points, while average expense ratios for index funds were only 59 basis points.

- **Technological advances might reduce the costs substantially in the future.** If fund allocations could be handled by an automatic telephone procedure or over the Internet, individuals could be permitted to reallocate their portfolios frequently at a relatively low cost.

KEY POINT #3: THE TSP MODEL

- **The Federal Thrift Savings Plan has been a model for many individual account proposals.** Its costs are low -- roughly 10 basis points per year, excluding employer costs of reporting individual earnings to the TSP.

  -- Costs are low in part because TSP offers only 3 investment options -- a stock index fund, a corporate bond fund, and a Treasury security fund -- and all three funds are passively managed. In addition, the participating "employers" (Federal departments and agencies) are large. Finally, the total pool of funds is large, and TSP runs a competitive process in issuing contracts to private fund managers to run the funds.

- **A national government-run system would face much larger challenges.** The TSP covers 2.6 million participants, all of whom work for one employer (the Federal government). A universal personal account system would eventually involve 180 million individual participants, who work for 6.5 million different employers.

  -- Last year over 55 million individuals called the SSA's 800 number. Many additional calls would need to be handled if individual accounts were set up. In recent testimony, Frank Cavanaugh, former Executive Director of the TSP, estimated that a Social Security reform plan modeled after the TSP "would require at least 10,000 highly trained Federal employees to man the telephone and answer employee questions."

- **Corporate governance issues could arise in a TSP-style plan.** Because the government would be contracting with a small number of private-sector managers to invest the aggregate holdings of the accounts, corporate governance issues could arise that are similar to those that would arise if Social Security were invested in equities.

KEY POINT #4: HOW WOULD SERVICES BE PERCEIVED?

- **How would services be perceived?** In a very inexpensive system, the services provided would likely be perceived as inferior to those provided under workers' other investment accounts such as 401ks and IRAs. For example, workers might have their contributions deposited into their accounts only infrequently, be given limited opportunity to reallocate their portfolios, and receive less frequent statements of account balances.

  -- Some analysts fear that people would be disappointed when they realize that under some forms of a TSP approach, deposits would not be made to individual accounts until October of the following year (the date at which SSA and IRS essentially finish reconciling the previous year's earnings). In 401k plans, contributions are made much more frequently.

  -- Others feel that the individual account will seem like a new tax cut and that people will be pleased to receive it. If a new policy is announced that every year $500 or 2 percent of earnings will be deposited into your account 90 days after you file your taxes, it will seem like a good deal.

- **Keeping costs low conflicts with features that give individual accounts their popularity**. Proponents of individual accounts hold up savings account booklets and suggest that people could have frequent reports on account balances, wide investment choices, and the ability to reallocate their portfolios whenever they want. These features would raise costs.

- **Political pressure for added services could drive up costs.** There might be political pressure to introduce additional services, such as emergency loans against the accounts. The additional services would drive up costs.

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Divider Title: 21

CORPORATE GOVERNANCE

KEY POINT #1: POTENTIAL PROBLEMS

- Some experts have proposed that as much as 50 percent of the Social Security trust fund be invested in equities. Under this scenario, the trust fund would be a very large share of the U.S. stock market. In fact, it could rise to as high as 15-30 percent of total equity holdings in 2030.
- Even smaller fractions could raise issues such as "the government is the largest single shareholder of 200 of the 500 largest companies."
- Additional possible implications of investing the trust fund in equities include:

  1. Political pressure on investment decisions. Political considerations could influence the manner in which the Trust Fund is invested.

  2. Corporate governance issues. The government will have to decide whether and how to exercise its right as a shareholder to choose corporations' managers and influence business decisions.

  3. Constraints on economic policy-making. Investing a large share of the Trust Fund in equities could constrain economic policies that affect stock prices.

  4. Similar issues are present with individual accounts. Some of the issues listed here could also arise under a system of individual accounts if the system were centrally administered and investors were limited to a small number of investment vehicles.

KEY POINT #2: POTENTIAL SOLUTIONS

A number of strategies have been suggested for limiting the risk of these adverse outcomes. Several of these strategies are interrelated.

- *An independent investment board.* Like the members of the Federal Reserve Board, the members of a Social Security Investment Board could be appointed to long overlapping terms, and could be subject to removal only "for cause." The Board could be empowered to determine its own budget and submit it directly to the Congress.

- *Qualifications.* Members of the board could be required to be from the private sector, and have substantial expertise in the investment industry, pension industry, or similar background. (Such qualifications are currently required of the TSP Board members.) Nominees could be rated as "well qualified," "qualified," or "not qualified" by some outside group in a procedure modeled on the rating of judicial candidates by the ABA.

- *Strict fiduciary duty.* The Board could be charged with acting in the sole interests of the beneficiaries of the Trust Fund, and no other interests, however meritorious.

- *Limited investment choices.* The experience of the state pension funds suggests that scope for non-economic investing is especially great when the available range of investment vehicles is broad. For example, some state funds are authorized to invest in local infrastructure, in-state equity funds, Ginnie Mae and Fannie Mae pools, residential mortgages, and small-business loans. By contrast, the Thrift Investment Board is authorized to invest in only five broad funds, and thus far has avoided any difficulty with issues related to corporate governance.

- *Proxy voting strategies.* Some have suggested that government-owned shares simply not be voted, or be voted in proportion to the votes of non-governmental shareholders. This approach would have the downside of effectively destroying one of the important sources of value in share ownership, namely the power to vote, and facilitating the ability of managers to be unresponsive to shareholders. In addition, minority shareholders could be turned into majority shareholders. One alternative strategy for dealing with this issue would be to require that the shares be voted by the private-sector firms serving as portfolio managers; these firms would be under fiduciary responsibility to act in the best interests of the beneficiaries of the plan. Another options would be to limit the share of any one company that the government could hold.

- *Culture of non-interference.* Since Congress could pass a law altering any of the safeguards, it will be important that a culture of non-interference develop around the independent board, similar to the culture surrounding the Fed.

Key Point #3: The New Canadian System

The Canada Pension Plan (CPP) is expected to begin investing in private securities in early 1999. Draft investment regulations have been proposed, and final regulations are expected to be issued later this summer.

- Investment decisions will be taken by a 12-member Investment Board (yet to be named). Each member of the Investment Board will serve a three-year term, can be reappointed, and will receive pay similar to that in the private sector.

- The members of the Investment Board will have a fiduciary responsibility to the fund; specifically, the Board members are to "manage any amounts transferred to it . . . in the best interests of the contributors and beneficiaries" of the CPP. They will be held to a "prudent person" standard, and members with special knowledge or skill will have a higher level of responsibility.

- By law, the fund will be prohibited from investing more than 20 percent of CPP funds in foreign markets (equities and bonds). However, there has been much speculation that this limit will be raised or eliminated.

- The draft regulations covering the first three years of operation call for all investment in equities to be undertaken passively (that is, via one or more indexes).

- The Investment Board will be prohibited from investing more than 10 percent of the fund in any individual company, and from owning more than 30 percent of the voting shares of any one firm. Some real estate holding would be permitted.

- After three years, the investment regulations will be reviewed by the Finance Minister and the provinces.

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Divider Title: **22**

RAISING THE RETIREMENT AGE

FRAMEWORK FOR ANSWERS:

- **This Is Clearly a Major Issue That Needs to Be Discussed During this Year's Debate. Increased Life Expectancy Combined With Early Retirement Are Primary Causes of The Social Security Problem -- Here and Around The World.**

  - *Life Expectancy Is Rising.* Not only is our senior population doubling in the next 30 years, but life expectancy among seniors is increasing dramatically. Sixty years ago, life expectancy for those at age 65 was about 77 for men and 79 for women. Today, it is 81 for men and 85 for women. And rising for both.

  - *More Americans are retiring earlier.* In 1962, only 18 percent of Americans chose to receive their Social Security benefits at age 62. By 1996, that percentage had more than tripled, to 60 percent. The reasons for the increase in early retirement are diverse -- but it is occurring across the world. In nearly every other industrialized country (especially Italy, Japan, Germany), the share of the population that is over 65 is rising even faster than in the US and retirement systems are being strained.

- **However, In Examining Any Proposal To Improve Social Security Solvency -- Including This One -- We Must Balance The Goal of Solvency With The Goal of Fairness. Thus, We Must Look Closely At This Proposal's Impact on Americans Who Have Physically Demanding Jobs.**

  - *Some Workers Can't Work Late Into Their 60s.* For manufacturing workers who have worked with their hands and kindergarten teachers who have stood on their feet, working late into their 60's may not be a real possibility. Therefore, we must balance the goals of solvency with fairness.

  - *Between 20 and 25 Percent of Workers Feel They Must Retire Early.* Today, 12 percent of the near elderly are already receiving disability benefits. And another 20-25 percent of those about to retire feel that they must retire because of health reasons or the fact that they no longer can do their physically demanding jobs.

- **As Part of This Social Security Dialogue, We Need To Come Up With The Best Possible Thinking To Balance The Solvency Concerns of Longer Lifespans With Fairness Concerns With People Working In Different Types of Jobs. Because This Issue Is So Important, I Hope We Will Discuss it at the White House Conference on Social Security This December.**

BACKGROUND ON THE RETIREMENT AGE

CURRENT LAW:

- **The Normal Retirement Age Is Currently 65.** But people can retire as early as 62, with reduced benefits.

- **1983 Reforms Gradually Raise the Normal Retirement Age to 66 for Workers Who Reach Age 62 in 2005.** Then the retirement age will remain at 66 until 2016, when it will begin increasing gradually again until it reaches 67 in 2022. The earliest eligibility age will remain 62.

  - The normal retirement age for someone who is 54 years old today is 66.

  - The normal retirement age for someone who is 37 years old today is 67.

REFORM PROPOSALS WOULD:

1. Phase in the retirement age increase from 66 to 67 more rapidly than is currently scheduled,

2. Raise the retirement age beyond 67, or

3. Index the retirement age to life expectancies.

BACKGROUND ON RETIREMENT TRENDS

AMERICANS ARE LIVING LONGER THAN IN THE PAST:

The challenges of financing the retirement of the baby boomers and of future generations of retirees are largely the result of good news -- people are living longer.

LIFE EXPECTANCY AT AGE 65			
Year turning age 65	**Male**	**Female**	**Total**
1940	12.0	13.7	12.9
1998	16.2	19.8	18.1
2030	17.7	21.1	19.4

- Increased longevity and reduced fertility imply a falling ratio of workers to beneficiaries. The ratio of workers to beneficiaries was 5.1 in 1960 and is 3.4 today. It is expected to fall below 2 in 2035 and reach 1.8 by 2075.

- Similar trends are occurring around the world. As the chart below shows, many countries are aging much more rapidly than the U.S.

RATIO OF PEOPLE AGE 65 AND OLDER TO PEOPLE AGES 20 TO 64 (In percent)			
	1990	**2010**	**2050**
Japan	19.3	35.8	60.1
Germany	23.6	32.9	57.5
France	23.4	27.2	48.4
Italy	24.3	33.8	66.7
United Kingdom	26.7	28.6	45.8
Canada	18.6	22.9	46.5
United States	20.8	21.3	37.0

AMERICANS ARE RETIRING EARLIER THAN IN THE PAST:

- In 1950, nearly half (46 percent) of men 65 and older were in the labor force. Today only 16 percent of men 65 and older are in the labor force. In 1950, 10 percent of women 65 and over were in the labor force, while 8 percent participate today.

- Over the past 3 decades, the percentage of Americans who receive Social Security retirement benefits before age 65 has increased dramatically.

PERCENTAGE OF FIRST RECEIPT OF RETIREMENT BENEFITS BY AGE				
Year/Age	62	63-64	65+	TOTAL
1962	18	19	63	100
1970	27.8	23.2	49.0	100
1980	40.5	22.2	37.3	100
1990	56.6	20.2	23.2	100
1996	60.1	18.3	21.6	100

EXPLANATIONS FOR WHY PEOPLE ARE RETIRING EARLIER THAN IN THE PAST:

- Social Security has made it possible for more elderly to afford to retire. In particular, the introduction of the early retirement age in 1961 (1956 for women) has enabled people to retire before age 65.

- Rising incomes have made it possible for some people to afford to retire even before they are eligible for Social Security.

- Private pension plans can create incentives to retire early.

- Society's attitude toward the appropriate age of retirement may have changed.

THE HEALTH OF THE ELDERLY IS IMPROVING, BUT SOME PEOPLE WORK IN PHYSICALLY DEMANDING JOBS:

- In a recent survey, one-quarter of retirees said that poor health was the most important reason why they retired.

- The percentage of workers approaching retirement who work in physically demanding jobs has been declining and is expected to decline further in coming decades. However, there remains a segment of the population, particularly the lower paid and African Americans, who tend to work in these physically demanding jobs.

- Estimates of the percentage of workers approaching retirement who are in physically demanding jobs range from 11 percent to over 30 percent depending on the definition used.

- A recent academic study concluded job flexibility -- particularly the ability to shift to part time work -- has a large impact.

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Divider Title: **23**

RAIDING THE TRUST FUND

<u>FRAMEWORK FOR ANSWERS:</u>

- **Unified Balance is Traditional Measure Used to Evaluate Budget.**

  - The unified balance is the same measure that has been used by all administrations going back to the Johnson Administration. The unified budget is the simplest and clearest measure of how much the government is taking in and how much the government is spending and it allows us to look out into the future to see if the government will be able to meet all of our obligations, including Social Security.

- **If A Dollar Comes Into Social Security, It Goes To Pay Current Benefits or If There Is Extra In Any Year, It Is Invested in Treasury Bonds And Is Paid Back To Social Security When The Money Is Needed. This Investment Is Backed By A Legal Commitment And The Full Faith and Credit of the United States Government That It Will Be Repaid.**

  - Every dollar received by Social Security is either used to pay current benefits or helps pay future benefits by being invested in special-purpose Treasury bonds, which represent a legal commitment *now* to finance Social Security later. Under the law, if Social Security requires funds and the Trust Funds have assets in them, the Treasury must make the funds available.

  - The special-purpose bonds held by the Trust Funds have the same legal standing as regular Treasury bonds, which are the benchmark of reliability in the world's capital markets.

- **Five Years Ago, When We Had $300 Billion Deficits, I Could Understand The Concern That We May Have Been Unable To Repay Meet Our Commitment -- But With Surpluses, That Concern Should Be Gone.**

  - When President Clinton took office, the deficit was $290 billion and there were real questions about whether the government would be able to meet its commitments in the future. Because of the fiscal discipline of the past five years -- instead of the $357 billion deficit in 1998 projected when we took office -- we will have a budget surplus for the first time since 1969. And over the next 10 years, we are projecting $1.8 trillion of surpluses.

<u>BACKGROUND:</u>

- According to OMB, the budget surplus will total <u>$1.8 trillion</u> over the next 10 years; CBO projects the surplus to be $1.55 trillion.

- In January 1993, the Congressional Budget Office projected the <u>deficit to be $357 billion</u> this year. In fact, this past year we had a $70 billion surplus.

- When President Clinton took office, the deficit was projected to be <u>$579 billion in 2002</u>. Today, we are projecting <u>a surplus of $148 billion</u>. That means that our fiscal situation in 2002 will be <u>$727 billion better than projected in January 1993</u>.

- In 2013, Social Security tax revenue will not meet Social Security expenditures. However, Trust Fund continues to expand until 2021 because of interest revenue earned on existing bonds. In 2021, the Trust Fund will gradually shrink as its bonds are redeemed. In 2032, the Trust Fund will be exhausted.

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Divider Title: **24**

TAXES

FRAMEWORK FOR ANSWER:

- **Should Not Have to Increase the Payroll Tax Rate as Part of a Comprehensive Plan.** As I said in the Kansas City forum, we should not have to increase the payroll tax rate as part of a comprehensive plan. From looking at the proposals that have been put forth so far, it seems clear that it is possible to design a comprehensive solution that does not include an increase in the payroll tax rate.

- **Many Ideas Have Been Proposed -- We Must Give Every Idea a Fair Hearing.** As part of an overall plan, many ideas are on the table. Ultimately, though, what we must consider is whether a comprehensive reform package meets the principles I set forth at the last conference.

- **Bipartisan Process for Fair and Workable Solution.** We are confident that through a mutually agreeable bipartisan process, we can come up with a fair and workable solution to strengthening Social Security for the future.

POTENTIAL QUESTION:

ARE YOU FOR RAISING THE MAXMIUM EARNINGS LIMIT OR EVEN COMPLETELY ELIMINATING IT?

- **As I Have Said Before, Completely Eliminating the Maximum Earnings Limit May Not Be Necessary as Part of Social Security Reform and Could Break the Link Between What a Worker Puts into Social Security and What He or She Gets Out.**

  - Currently, Social Security taxes are assessed on earnings up to $68,400. This level increases every year with inflation.

- **However, I Do Not Want to Put On or Take Off the Table Any Proposal at This Time.**

  - At the Kansas City conference, you said that a modest increase in the cap is among the options that should be debated this year.

BACKGROUND:

- Some have argued for raising or even eliminating the cap. Currently, 6 percent of workers earn above $68,400. Some proposals would gradually raise the cap by between 15 and 25 percent. For example, under Senator Moynihan's proposal, the taxable maximum in 2003 would reach $97,500 instead of the $82,800 it is expected to reach under current law. Others have proposed phasing in the increase more slowly -- for example by 2015.

FOLLOW-UP QUESTION:

SPEAKER GINGRICH HAS PROPOSED REPEALING THE 1993 INCREASE IN THE PERCENTAGE OF BENEFITS SUBJECT TO TAXATION. DO YOU SUPPORT THIS PROPOSAL?

- **I Believe We Must Resist the Temptation To Say Something About A Social Security Proposal Now That Would Help 10-15 Percent of Retirees And Goes Against Our Efforts To Maintain Fiscal Discipline.**

- **I Am Also Concerned That This Proposal Would Help 10-15 Percent of Social Security Recipients While Moving The Insolvency Date of the Medicare Trust Fund Closer For Everyone.**

BACKGROUND:

- The partial tax on Social Security benefits does not apply to seniors with income below $25,000 if single or $32,000 if married. In 1997, only 25 percent of beneficiaries were subject to taxes on their Social Security benefits.

  - For those with income above $25,000 if single and $32,000 if married, up to 50 percent of benefits are taxable. The fund are credited to the Social Security Trust Funds.

  - For those with income above $34,000 if single and $44,000 if married, up to 85 percent of benefits are taxable. The *additional* revenue from this provision is credited to the Medicare Trust Fund.

- One common proposal would extend the tax on Social Security benefits to all persons subject to Federal income tax by phasing out the current income thresholds. Even if the thresholds were completed phased out, other provisions in the tax code (e.g., standard deduction and exemptions) would ensure that 30 percent of beneficiaries (those at the lowest income levels) would still not have to pay taxes on their benefits.

- Other proposals would also tax Social Security benefits like other pensions. The proposal would tax benefits -- on an individual-by-individual basis -- to the extent that benefits exceed what workers had paid in. This treatment would mirror the tax treatment of other defined-benefit pension plans.

- Making *both* changes would *reduce* the long-run imbalance in the Social Security system by 0.36 percent of payroll -- relative to the current gap of 2.19 percent.

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Divider Title: **25**

MEANS TESTING

FRAMEWORK FOR ANSWERS:

- **The President Believes That Social Security Reform Must Be Fair for All Americans -- But We Most Look At How Fair and Progressive Is A Comprehensive Plan, Not Any One Provision.**

- **For Example, The President Is Certainly Not In Favor Of Comprehensive Reforms That Put An Undue Burden On Lower-Income Americans.** The President believes that the Social Security system must be progressive and fair to those who need it most. This is one of the principles he announced at the Kansas City forum earlier this year.

- **The President Also Believes That Social Security Should Be A Universal Program.** This is also one of the five principles he put forth in Kansas City. Everyone pays in to the system, and everyone benefits.

Additional Point to be used <u>ONLY IF NECESSARY</u>:

- **In 1983, President Reagan and Congress Addressed These Concerns -- and We Did the Same Thing in 1993 for Very High Income Beneficiaries.** In 1993, as part of our economic plan, we did ask the top 13 percent of Social Security beneficiaries to include more of their benefits in taxable income, while protecting the vast majority of beneficiaries from any such increase.

BACKGROUND:

- Currently, Social Security benefits are not means-tested. Some proposals would means test the benefits by reducing them by a given amount for every $1 of income over some threshold.

- Subjecting benefits to income tax accomplishes many of the goals of means-testing benefits. For those with income above $34,000 if single and $44,000 if married, our 1993 Economic Plan made up to 85 percent of Social Security benefits taxable. The additional revenue from taxing benefits at 85 percent rather than 50 percent is credited to the HI Trust Fund, not the Social Security Trust Funds.

- At various times, we have showed openness to means testing the premium subsidy for high-income beneficiaries in the Medicare program. In *Putting People First*, we supported means testing of Medicare -- raising Part B premiums for those earning more than $125,000. We included a similar proposal in the 1994 Health Care plan and we showed openness in 1997 as long as the provision was administratively feasible and did not fully eliminate the premium subsidy which would have given incentives for higher-income individuals to withdrawal from the system.

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Divider Title: **26**

COVERING STATE AND LOCAL WORKERS

FRAMEWORK FOR ANSWER:

- **Clearly An Idea That Is On The Table, But Pros and Cons Need to Be Weighed.** This proposal has been included in many reform plans. But before we reach any conclusions, we need to study carefully the pros and cons.

Advantages of This Proposal Are:

- **Social Security Coverage Has Expanded Significantly.** Since the Social Security Act of 1935, coverage has expanded from workers in business and industry to almost all Americans.

- **State and Local Government Workers Are Final Group Not Covered.** Many people have argued that state and local government employees are the final sizable group of workers not universally covered (nonetheless, about 70 percent of state and local workers receive benefits for various reasons). Being covered under Social Security would allow state and local workers to move from one job to another without losing coverage. Proposals are to cover newly hired state and local workers, not existing workers.

Disadvantages of This Proposal Are:

- **But Impact on Existing State and Local Programs Needs to Be Carefully Examined.** I know that the impact of the proposal would vary greatly across the nation, and that some people are concerned about its effect on existing state and local retirement programs. So we will need to look carefully at this and other proposals over the coming year, to figure out which changes are best as part of a comprehensive Social Security reform.

BACKGROUND:

- Since the Social Security Act of 1935, coverage has expanded from workers in business and industry to include the self-employed, nonprofit groups, agricultural and household workers, the Armed Services, Congress, and all other Federal employees hired after 1983. In 1998, 96 percent of all workers are covered under Social Security -- up from 55 percent in 1939.

- State and local government employees are the final sizable group of workers not universally covered by Social Security. If such workers are mandatorily covered under a state or local public pension system, they are not mandatorily covered under Social Security. Roughly 25 percent of state and local workers are not covered under Social Security. Many of these workers are in California, Ohio, New York, and Texas. In New Mexico, about 17 percent of state and local government employees are not currently covered by Social Security.

- Many proposals would expand mandatory Social Security coverage to state and local government workers hired after a certain date. Such proposals would close roughly 0.2 percent of the current 2.19 percent gap. Moving newly hired workers out of the state and local programs that would otherwise cover them could put financial pressure on some state and local programs -- although a gradual phase-in could attenuate any such pressures.

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Divider Title: **27**

REDUCING COST OF LIVING ADJUSTMENTS

FRAMEWORK FOR ANSWERS:

- **We Are Committed to The Most Technically Accurate Index.** The issue of whether we should change the COLAs in order to better reflect inflation is a legitimate one, but one that needs to resolved by experts. The administration is strongly committed to using the most technically accurate index.

- **COLAs Affect Millions of Americans.** The COLAs affect 44 million Americans through the Social Security program, and millions more through other programs (including the tax code). Any change in the COLAs should be carefully considered to assure that the most vulnerable elderly and lowest-income retirees are not put in jeopardy.

- **BLS is Making Improvements.** The Bureau of Labor Statistics is continuing to make improvements in the CPI, and many economists believe that they are making good progress. Alan Greenspan recently testified that the "BLS has done such a good job recently...I must say -- they have done really an excellent job over the last couple of years." According to Janet Yellen, recent and planned changes will reduce the CPI inflation rate by about 0.33 percentage point per year more than was previously anticipated.

- **COLA for this Year Will Be 1.3 Percent.** Recent COLAs have been relatively small because inflation has been low. The COLA payable in the January 1999 benefit check will be 1.3 percent for OASDI benefits.

BACKGROUND:

- The cost-of-living adjustment within Social Security is set each year on the basis of the increase in the CPI-W over the year ending in the third quarter of the previous year.

- In December 1996, **the Boskin Commission** concluded that the CPI was overstating increases in the cost of living by 1.1 percentage points per year. Most of the President's economic advisers believe that the CPI does overstate increases in the cost of living, but that the Boskin figure was too high.

- Since the Boskin Commission report was issued, the BLS has been working to address many of the biases in the CPI. According to Janet Yellen, recent and planned changes would reduce even the Boskin estimate by about 0.33 percentage point per year -- to about 0.8 percentage point per year.

- Reducing the COLA by 1 percentage point per year reduces lifetime benefits for the average retiree by roughly 10 percent, and reduces the long-run actuarial imbalance in the Social Security system by 1.4 percent of taxable payroll (out of current gap of 2.19 percent).

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Divider Title: **28**

RATES OF RETURN

FRAMEWORK FOR ANSWERS:

- **Rates of Return on Social Security Are Positive, Even after Accounting for Inflation, for Almost All Workers.**

  - Although rates of return to Social Security are lower than they once were, they remain positive, even after accounting for inflation, for almost all workers.

- **Rates of Return Could Be Raised Either Through Individual Accounts or Through Investing Some of the Trust Funds in the Stock Market.**

  - A key question in this year's national discussion is whether it will be possible to achieve higher rates of return in the future using individual accounts or trust fund investments in equities. Both approaches need to be explored carefully in the context of a comprehensive plan, to see whether they meet the principles the President have put forward. In particular, Social Security must remain a program that everyone can depend on.

- **Must Not Forget about Transition Costs.**

  - Sometimes people argue that if they could opt out of Social Security and invest on their own they could do better than they do in Social Security. But this ignores the fact that 90 percent of today's payroll tax goes to pay benefits for current beneficiaries. If current workers put their payroll tax contributions into individual accounts for their own retirement, we will need to come up with some other way to pay retirement benefits for people who are entitled to Social Security benefits. Rates of return that ignore this cost are misleading when compared to Social Security rates of return that include this cost.

- **Social Security Is More than a Retirement Program.**

  - It provides disability insurance and survivors' insurance -- each is equivalent for the average young family of four to an insurance policy worth about $300,000 ($600,000 in total). And it is low risk; its benefit is always there for you, no matter what happens to stocks, interest rates, or inflation. But most importantly, it reflects our fundamental values and a social compact.

REAL RATE OF RETURN TO SOCIAL SECURITY CONTRIBUTIONS
(Percent per year)

Year born/ year age 65	Single male earner			One-earner couple		
	Low earnings	Avg. earnings	High earnings	Low earnings	Avg. earnings	High earnings
1920/1985	4.4	2.8	2.5	8.1	6.6	6.3
1930/1995	3.1	1.9	1.5	6.1	5.0	4.7
1964/2029	2.4	1.3	0.7	4.7	3.7	3.1
2004/2069	1.5	0.8	0.2	4.0	3.0	2.4

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Divider Title: ______________________________

ELIMINATE THE EARNINGS TEST

KEY POINTS:

- **This Is One of the Important Issues That Needs to Be Discussed Because There Are Serious Arguments on Both Sides.**

- **Some Say Social Security Benefits Should Go Only to People Who Are Retired.** Some believe that it makes sense to reduce Social Security benefits for people who continue working because FDR's Committee on Economic Security recommended that no benefits be paid before a person had "retired from gainful employment." Various forms of earnings limits have always been part of the program.

- **Others Argue That This Is An Outdated Provision That Provokes Unnecessary Confusion and Prevents People from Doing Part Time Work That Would Be Good for Them.** While retirees get back these lost benefits, on average, through the delayed retirement credit which provides them with increased benefits once they stop working, many elderly workers perceive the earnings test to be unfair and an impediment to work. They argue that removing the earnings test would help people make the right choice about whether or not to work. In addition, they say it would make the system more understandable and easier to administer.

- **In 1996, Working Closely with Members of Congress from Both Parties, I Signed Legislation That Will Gradually Double the Earning Limit for People Between 65 and 70.**

KEY FACTS:

- Currently, Social Security recipients who are between the ages of 62 and 69 have their benefits reduced if their earnings exceed a certain amount. Recipients under 65 lose $1 of benefits for every $2 of earnings above $9,120. Recipients between 65 and 69 lose $1 of benefits for every $3 of earnings above $14,500. (The benefits of recipients who are aged 70 or above are not affected by the limit.)

- In 1996, working with both Democrats and Republicans in Congress, you signed into law annual increases in the earning limit for those between 65 and 70. Between 1998 and 2002, the limit for workers in this age range will increase from $14,500 to $30,000.

- Because benefits foregone are given back through the delayed retirement credit, eliminating the earnings limit would have almost no effect on the long-run actuarial balance of the OASDI program. Such a change would have significant short-run budget effects, however. Removing the earnings limit for those aged 62 and above would raise Social Security expenditures by roughly $12 billion in 2001 *alone*.

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Divider Title: **30**

- **The Chilean privatization has influenced Social Security debates across the world.** The Pinochet dictatorship established the current system in 1981. Benefits are based on either (a) a general-revenue-financed minimum benefit, or (b) the proceeds of an individual account. To cover the transition costs (paying workers for the benefits they had accrued entitlement to under the old system), the government issued new debt, known as recognition bonds.

  -- The minimum benefit is set at either 75 percent of the poverty rate or 25 percent of the worker's average pay over 10 years, whichever is greater. The minimum benefit is paid only if the individual account generates an annual benefit below the minimum. A worker cannot collect from both tiers: if a retiree collects the minimum benefit, he or she surrenders the proceeds from the individual account.

  -- The individual account is financed by a mandatory employee contribution of 10 percent, supplemented by additional voluntary contributions of up to 20 percent of wages.

- **Advocates of Social Security Privatization hail Chile as a success**. Supporters attribute Chile's 7 percent growth rates directly to social security privatization and they also credit the new system with increasing national saving. Projected benefits are 40 to 50 percent above those under the old system, and the funds realized real rates of return that averaged 10 percent during the decade of the 1980s (Chile's stock market performance has been much weaker recently). In addition, supporters argue that the new system has de-politicized the setting of benefits, because benefits (other than the minimum) are tied to the performance of the individual accounts.

- **There are reasons why the Chilean experience is not applicable to the U.S.** Many economists have argued that Chile's economy has improved because the economic reforms accompanying privatization have enhanced the appeal of Chilean capital markets and improved their efficiency. The U.S. already has well developed financial markets, and has little to gain along these lines from reform. In addition, the low-level of benefits under the old system and the relatively small fraction of the Chilean population that was old, meant that transition costs in Chile were much smaller than they would be in the United States.

- **The big drawback of the Chilean system has been high administrative costs.** The accumulation of administrative costs over a worker's career results in retirement income in the Chilean system that is 20 percent lower than it would be if there were no administrative costs.

  -- In Chile, fund management companies appear to compete on factors other than price. The funds are highly regulated in the types of allowable investments, and offer very similar portfolios. Individuals are allowed to switch portfolios every 4 months. This has caused fierce competition. The funds spend huge amounts on advertising, have increased their sales forces, and offer incentives such as televisions or trips to lure individuals to their particular fund. This non-price competition has driven up costs.

  -- In Chile there are 3.5 salespeople per 1,000 contributors. In the United States, there are 0.5 SSA employees per 1,000 insured workers.

- **Reforms over the past decade have greatly reduced the UK's long term financing problem.** In the mid-1980s, Prime Minister Margaret Thatcher's Conservative government introduced a series of reforms partially privatizing the existing state pension system. As a result of these reforms, the British system does not face the same type of looming financing problem that the U.S. and many other European nations are currently confronting. Although the number of workers per beneficiary in the U.K. is expected to fall from its current level of just over 2 to about 1.6 by 2030, the cost of promised benefits is actually expected to *fall* as a percentage of GDP, from 4.2 percent currently to 3.3 percent in 2030.

- **The UK now has a two-tiered system.** The first tier provides a basic flat-rate pension. The second tier provides a benefit based on an individual's earnings history and workers can choose whether to take the state provided benefit or to opt-out of the state system in favor of an employer or individual pension.

  -- *The Basic State Retirement Pension.* The first tier consists of the basic state retirement pension (BSP), a flat-rate benefit that pays most beneficiaries approximately $105 per week. The BSP is funded on a pay-as-you-go basis through a portion of the payroll tax. The BSP provides about one-third of total income for retirees, and costs roughly 4 percent of GDP.

  -- *The State Earnings-Related Pension Scheme.* The most basic of the second tier options available to workers is the State Earnings-Related Pension Scheme (SERPS). At present, about one-fifth of British workers are enrolled in this program, which provides a publicly-funded pay-as-you-go benefit based on earnings history. When it was first introduced in 1975, SERPS was based on a worker's highest 20 years of earnings, indexed to average earnings. Subsequent changes, however, have made the program less generous. These changes, which were introduced in the mid-1980s, were intended to reduce the state's financial obligation and to encourage participants to switch to either employer- or individual-based privatized systems.

  -- Contracted out options. Workers who opt out of SERPS have two other second tier options available to them: an employer-based system and an individual-based system. Those who choose either of these options (or "contract out") have a payroll tax rate that is 4.6 percentage points lower than the contracted-in rate.

  Employer-Based Pension. One option available to those who wish to contract out of SERPS is to participate in an employer-sponsored pension plan (often referred to as an "occupational pension"). About half of all workers choose this option. Occupational pensions can be either defined-benefit or defined-contributions plans; at present DB plans are more common. In order to qualify for the lower contracted-out tax rate, occupational DB pensions must meet certain standards; most plans are more generous than SERPS.

  Personal Pension The other way to achieve contracted-out status is through a personal pension, which is similar to an IRA. About 17 percent of workers are enrolled in personal pensions. Workers enrolled in a personal pension must deposit the contracted-out rebate of 4.6 percent into their account.

- **While the financing problem has been solved, their are serious concerns about the adequacy of retirement benefits in the UK.** The size of the basic state benefit is indexed to inflation. Since real wages have been increasing, however, the benefit has fallen from about 20 percent of average earnings in 1977-78 to about 15 percent currently. By 2030, the ratio of BSP to average earnings is expected to drop to 9 percent. This presents a particular problem for low earners, since the BSP is likely to account for a large portion of their benefits once they retire. Similarly, reductions in the generosity of SERPS has resulted in some workers having low retirement income.

- **Administrative costs in the early years of the UK individual account system have been high.** A recent paper by Professor Peter Diamond reports that the charges for these individual accounts are large, complicated, and often not visible to the workers. He calculates that the total administrative costs in the typical UK account reduce retirement income by more than 24 percent. The lesson from the Chilean and UK two examples is <u>not</u> that individual account systems are necessarily expensive, but rather that it is important to design systems in a way that provides the desired services at a reasonable cost.

- **The mis-selling scandal shows that careful regulation of privatized systems is necessary.** Overly aggressive marketing techniques by providers of personal pensions in the UK have misled a large number of workers into choices that were not in their own best interest. For example, although occupational pensions turn out to be better investments than private pensions in most instances, there are numerous and repeated examples of the banks and insurance companies advising workers to drop out of more beneficial occupational pensions to purchase personal pensions instead. In what has been dubbed the "Mis-selling Scandal," at least 600,000 cases of pension mis-selling have been identified, and the final total may be 2 million. Regulators have already levied fines on insurers and financial advisors of more than $7 million, and Scotland Yard is conducting a criminal investigation related to the scandal. In order to fend off lawsuits, many insurers are voluntarily reimbursing investors for the losses they suffered based on the bad information they received; one insurer has set aside $1 billion for this purpose. When all is said and done, this scandal is expected to cost British insurers roughly $18 billion.

Social Security Reform in Canada

Canada has recently decided to invest the assets of its Social Security system in private securities beginning in early 1999. This will provide an important test of the feasibility and desirability of a policy of trust fund investments in private securities.

Draft investment regulations have been proposed, and final regulations are expected to be issued soon.

- Investment decisions will be taken by a 12-member Investment Board (yet to be named). Each member of the Investment Board will serve a three-year term, can be reappointed, and will receive pay similar to that in the private sector.
- The members of the Investment Board will have a fiduciary responsibility to the fund; specifically, the Board members are to "manage any amounts transferred to it . . . in the best interests of the contributors and beneficiaries" of the CPP. They will be held to a "prudent person" standard, and members with special knowledge or skill will have a higher level of responsibility.
- By law, the fund will be prohibited from investing more than 20 percent of CPP funds in foreign markets (equities and bonds). However, there has been much speculation that this limit will be raised or eliminated.
- The draft regulations covering the first three years of operation call for all investment in equities to be undertaken passively (that is, via one or more indexes).
- The Investment Board will be prohibited from investing more than 10 percent of the fund in any individual company, and from owning more than 30 percent of the voting shares of any one firm. Some real estate holding would be permitted.
- After three years, the investment regulations will be reviewed by the Finance Minister and the provinces.