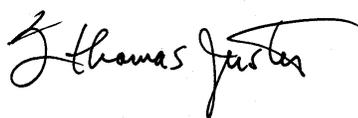


Director's Corner

When the Social Security Administration's Retirement Research Consortium (RRC) was established about three years ago, the founders had hoped that the centers would foster high quality research that would inform pressing retirement policy issues. Now entering its fourth year, the MRRC is meeting that goal. In conjunction with specialists at the SSA, we have successfully established the infrastructure that promotes the mandates of Social Security and retirement-related research, dissemination, training, and data usage. As demonstrated by the Brief featured in this issue and the list of newly funded MRRC research projects, MRRC researchers are and will continue in the future to be engaged in timely and highly policy-relevant work.



Acting Director, MRRC

Issue in Brief

Personal Accounts and Social Security Reform

By Olivia S. Mitchell

Personal accounts are appealing in the context of Social Security reform for several reasons. One is that such accounts would give workers ownership and a degree of responsibility over their own retirement saving. Another is that personal accounts would afford participants an opportunity to pass wealth to survivors in the event of premature death. Personal accounts would also benefit divorced persons who are not eligible to receive Social Security spousal benefits unless they remain married ten years. Yet another factor favoring personal accounts is that workers could choose how to allocate their retirement saving and diversify their investments over a

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range of capital market assets. Some also argue that personal accounts would provide *all* workers a higher rate of return than can be paid under the current Social Security system. In this *Issue in Brief*, I explore the limits of this last argument. I show that Social Security returns are projected to be low mainly because today's workers are committed to paying for the system's past debt. After clarifying several key terms, I discuss reform scenarios involving these concepts.

Social Security's Financial Status¹

The Old-Age and Survivors' Insurance program, known as OASI, is financed mainly by a 12.4 percent payroll tax on covered earnings of wage earners; some money is also received from the taxation of benefits.² Beginning in 2016, OASI is projected to collect less in tax revenues than it must pay out in benefits. As noted in the *Interim Report* of the President's Commission to Strengthen Social Security, the Trust Fund would still show a positive balance at that time. Going forward, however, cash flow annual shortfalls will grow quickly, to \$99 billion in 2020, \$194 billion in 2025, \$271 billion in 2030, and \$318 billion in 2035 (in 2001 dollars). The system's future liability is estimated at around \$10 trillion. The cost of paying scheduled benefits will rise from about 10 percent of taxable wages today to almost 18 percent in

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For Your Information

Easy Way to Pay Off Debt

There's a new way to pay off your debt to the IRS. Many Social Security beneficiaries are choosing to have money withheld from their benefit checks to satisfy federal income tax liabilities. After all, sometimes the easiest way to pay off a debt is to never get the money to begin with. If you owe money to the IRS, you can select to have a percentage of your check taken out to pay off your debt. Link to the form, print it, complete it, and deliver it to your Social Security office. Then you don't have to worry about writing that check to the IRS.

<http://www.ssa.gov/online/w4v.pdf>.

MRRC research awards for 2001-2002

We are pleased to announce the recipients of research awards for the coming year.

Hugo Benitez-Silva, *"The Annuity Puzzle Revisited: Implications for Social Security Reform"*.

Charlie Brown, *"Early Retirement Windows"*.

Debra S. Dwyer and Hugo Benitez-Silva, *"Dynamic Retirement Expectations using the Health and Retirement Study"*.

Michael J. Greenwood and Paul S. Davies, *"Welfare Reform and Immigrant Participation in the Social Security Income Program"*.

Alan L. Gustman and Thomas L. Steinmeier, *"Using the Health and Retirement Study to Simulate the Effects of Voluntary and Mandatory Systems of Social Security Privatization"*.

Alan L. Gustman and Thomas L. Steinmeier. *"A Structural Model of the Family that Jointly Explains Retirement and Saving Behavior, with Analyses of the Effects of Current and Proposed Social Security Policies in a Family Context"*.

Michael Hurd and Julie Zissimopoulos, *"Saving for Retirement: Wage Growth and Unexpected Events"*.

John Laitner, *"Endogenous Labor Supply Responses to Social Security Reform"*.

Ken Langa, Caroline Richardson and Sandeep Vijan, *"Implications of High Risk Health Behaviors on Work-Force Participation: Disability, Retirement and Lost Productivity"*

David Loughran and Steven Haider. *"How Important Are Wages to the Elderly?"*.

Olivia S. Mitchell, John W.R. Phillips and Sylvester Schieber, *"Representative versus Actual Lifetime Earnings Trajectories"*.

Elizabeth T. Powers and David Neumark, *"Multiple Program Use by Older Americans: Social Security Early Retirement and Supplemental Security Income"*.

Robert F. Schoeni, *"Understanding Poverty Among Elderly Divorce Women"*.

Matthew D. Shapiro and Miles S. Kimball, *"The Retirement Elasticity: Theory and Implications"*.

Robert J. Willis and Gabor Kezdi, *"Subjective Probability Distributions and the Decision to Save"*.

Full descriptions of the newly awarded projects as well as those for previously funded research are available at www.mrrc.isr.umich.edu/research/research.cfm.

MRRC booth at the American Economic Association Meetings in Atlanta

The MRRC conference booth appeared recently at the AEA Meetings in Atlanta, January 3-6 2002. MRRC staff were available to respond to inquiries from conference attendees. In addition, the booth made available to materials including MRRC working papers, Issues in Brief, a list of research topics, current and previous Center newsletters, and MRRC brochures. The Boston Center for Retirement Research shared this booth with one staff representative and similar materials for distribution. The booth will appear next at the Population Association of America 2002 Annual Meeting May 9-11 in Atlanta, Georgia.

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2035. The fact that projected costs will balloon while program revenue lags behind means that as a nation, Americans face some unavoidable choices.

Why Social Security Is In Debt

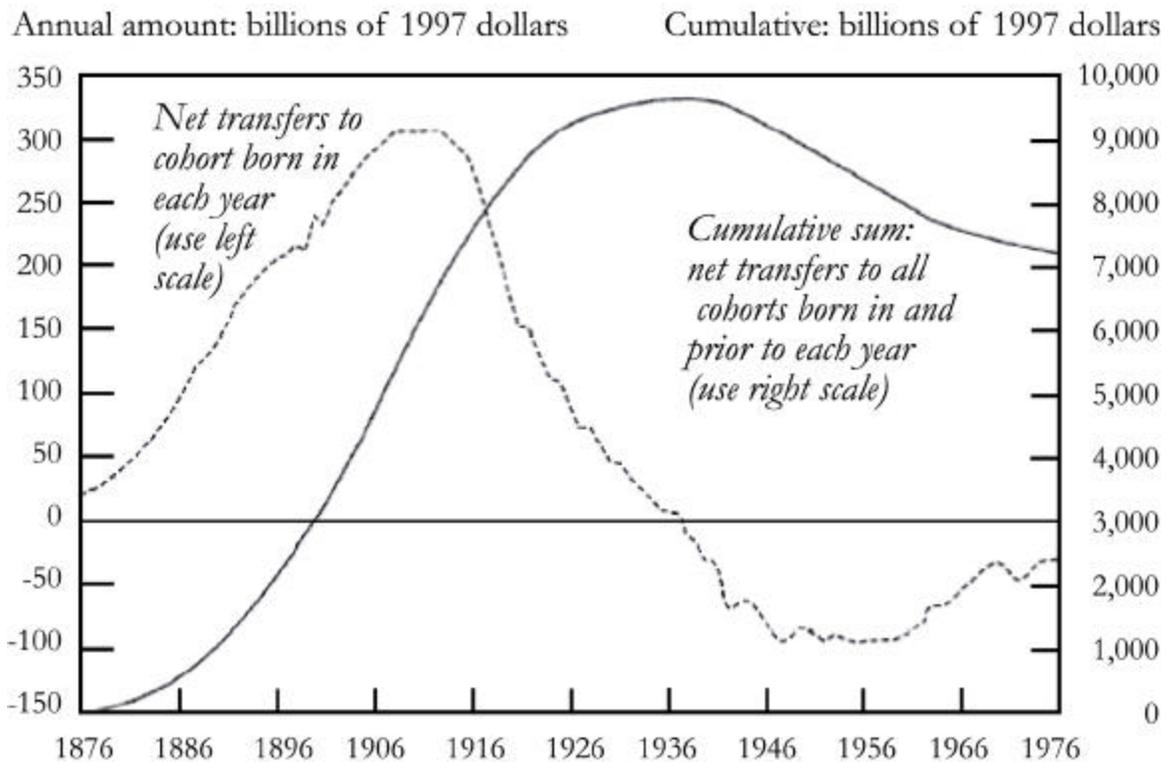
Social Security was initially designed to be a prefunded program, meaning that retirees' benefits would be based on how much workers paid into the system. But after the program was launched, political pressure expanded benefit payments to encompass more people and richer benefits than initially envisaged, including to the already-elderly, early retirees, survivors, and dependents. Paying benefits to many people who had not contributed very much to the system meant that over time, Social Security ceased being prefunded and moved to a "pay-as-you-go" (PAYGO) program. That is, the system took on debt by paying more out in benefits to retirees than these people had contributed during their worklives, and the burden was passed on to future generations.

As a result of coverage broadening and benefit increases, early participants got back more than they paid into the system. Knowing what we do about the system's historical evolution, it is not surprising to find that the several early generations of retirees received a high Social Security "rate of return" on their money. (The Social Security money's worth literature identifies this rate of return as the discount rate that equates a worker's lifetime payroll taxes and lifetime retirement benefits.) For instance, workers born in 1876 (the first generation to receive benefits) received a rate of return of more than 35 percent per year. Those born in 1900 received less than half this amount, around 12 percent. As the system matured, workers paid in more money over longer periods, and the rate of return continued to drop.

Future Social Security returns will fall further, under present law. The dotted line in the figure below shows the amount of money in benefits transferred through the Social Security system to generations born 1876 through

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Social Security Net Intercohort Transfers



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- **Conferences and Events** are listed that may be of interest to researchers, policymakers, and the general public interested in retirement and social security.
- **Training and Education** provides information about *pre and post doctoral fellowships* available through MRRC, graduate coursework at the University of Michigan, training workshops and seminars.
- **Research and Findings** presents an array of materials representing the work of Center researchers including *Issues in Brief, Conference Papers, Working Papers*, and the *Newsletter*.
- **Data** directs potential users to valuable sources of data for retirement research.

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1976 (in 1997 dollars). This line indicates that the first 60 birth cohorts of workers paying into the Social Security system received a positive transfer, that is, they received more back in benefits than they paid in taxes. Starting with the cohort born in 1937 and continuing thereafter, however, net transfers moved negative. The solid line shows the cumulative sum of these transfer payments.

In a PAYGO system, money flowing into and out of the system must sum to zero over time. Therefore, since past generations received more than they paid in, current and future generations must receive less. How much less each generation of future workers receives depends on how the cumulative debt of about \$10 trillion is spread out. If policymakers simply rolled the debt forward, paying interest but doing nothing else, one-quarter of every payroll tax dollar flowing into Social Security would be needed to paying interest on this obligation. That is, of the 12.4 percent of payroll currently paid to Social Security, 3.6 percent covers interest on this unfunded debt. As a result, as long as the debt is rolled forward, the long-run return on Social Security payroll taxes will be depressed due to the need to honor past debt.

Social Security Prefunding, Diversification, and Personal Accounts

When assessing measures to reform the system, it is important to emphasize that *prefunding, diversification, and personal accounts* are distinct concepts in the Social Security

context. Prefunding requires reducing the debt held by the current system, which could be accomplished in a variety of ways. In essence, it would require curtailing system liabilities or boosting system revenue. Revenue could be increased by raising taxes on current workers, meaning that later cohorts would enjoy lower taxes, or by taxing future workers, thus leaving current workers less affected. Curtailing liabilities could be accomplished by cutting current retiree benefits, an option that is distinctly unpopular in most circles, or by lowering the rate of benefit growth for future retirees.

Diversification means investing Social Security payroll taxes in capital market assets such as stocks and bonds. Setting up personal accounts would entail changing the Social Security system to include accounts held and managed by individual workers.

My research shows that reform plans can include any or all of these three concepts. For example, Latvia has “virtual” but unfunded personal accounts, which are therefore undiversified. Switzerland invests its national retirement money in stocks as well as bonds, so that the system is both diversified and prefunded but does not include personal accounts. Mexico provides its workers with prefunded mandatory personal accounts, but until recently, the government required these to be invested solely in government bonds (diversification is planned for this year). Chile, leading several of her sister nations in Latin America, established mandatory, prefunded,

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diversified, personal accounts. These and other models are under active debate in the United States at present.

Individual Accounts without Diversification or Prefunding

What if the US Social Security system were to transition to a personal accounts system without drawing down past debt accumulated under the old program? This is not an approach that most mainstream analysts recommend, since it would entail shutting down the current system and depositing all new Social Security payroll taxes only in personal accounts. In this case, honoring past promises might involve issuing so-called "recognition bonds" equal to the system's current unfunded promises. On the assumption that the nation would not default on Social Security debt, new taxes would have to be raised to cover the interest as well as eventually to redeem the bonds. Under this scenario, the net result would be that workers would reap higher returns in their personal accounts, but new taxes would offset some of these gains when viewed as a whole. Those who critique low returns now promised by OASI today generally ignore the unavoidable cost of honoring past Social Security debt, where the only alternative is to default on the promised payment.

Is Diversification the Key?

Many policymakers favor personal accounts because these afford workers a chance to hold a diversified asset portfolio, particularly with stocks included as part of the mix. Since stocks pay a higher expected rate of return,

proponents argue that workers would benefit from taking advantage of the equity premium. Of course, higher expected returns must be balanced in each case against exposure to more risk. Some people would welcome this, while others might not.

On balance, it is likely that people who currently have no retirement saving might benefit the most from access to the capital market through a diversified personal account under Social Security. This set of workers is also most vulnerable to the uncertainty associated with today's insolvent Social Security system, since their future benefit promises cannot be counted on in light of the troubled finances outlined above. People who already have a diversified personal savings portfolio would perceive less relative gain from personal accounts, since for them, the risk-adjusted rate of return on stocks is identical to that on bonds.

One unknown, going forward, is whether personal accounts might influence market values of stocks and bonds. Some speculate that if the demand for equities rises during the saving phase, this might boost stock prices early but when baby boomers retire, prices might fall. Potential market reactions have not yet received much research attention, but experts believe that personal accounts under Social Security would track the positive experience of 401(k) plans in the American financial scene.

Do Personal Accounts Raise Social Security Costs?

Some have argued that instituting funded personal accounts within the Social Security context might mean increased costs for Social Security. The claim is that a

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Barnhart New Social Security Commissioner

Jo Anne B. Barnhart was sworn in on November 14, 2001 as the Commissioner of Social Security in a ceremony at the SSA's national headquarters in Baltimore. Barnhart was sworn in by Larry G. Massanari, Regional Commissioner, Philadelphia. Massanari served as Acting Commissioner of Social Security since March. Barnhart is a former SSA employee. Most recently, she has served as a member of the Social Security Advisory Board, an independent body created to advise the Congress on Social Security issues and policies. Barnhart served as a member of the Board for more than four years. She will be responsible for administering the Social Security retirement, disability and survivors insurance programs, as well as the Supplemental Security Income program. Barnhart is the 14th Commissioner of Social Security. Her term will expire on January 19, 2007.

Source: Social Security On-Line www.ssa.gov

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dollar sent to a personal account would be a dollar less to keep the Social Security system's cash flow positive. My earlier graph, however, shows that unfunded past Social Security debt exists independent of personal accounts. Arguing otherwise ignores the nature of the underfunded PAYGO system. One way to see this is that a personal account model could be established without any impact on Social Security's net liabilities, as outlined in the *Final Report* of the President's Commission to Strengthen Social Security. This could be done, for example, by adding-on voluntary contributions on top of existing payroll taxes so system finances would be unaffected. Another approach would be to allow workers to voluntarily divert some of their payroll taxes to a personal account, in exchange for a proportional offset to traditional Social Security benefits. This could be done in such a way as to leave the financial gap under the PAYGO system untouched. In other words, other reforms are still required to rectify the fundamental system shortfalls, such as raising new revenue or reducing the rate of growth of benefits below current unsustainable levels.

Another concern sometimes expressed is that the fees and charges associated with managing personal accounts might be steep. But international as well as domestic evidence show that these costs can be kept quite low with sensible plan design. For instance, collecting the personal account contributions centrally is a much lower-cost approach than is a decentralized collection model. Investment charges can be minimized as illustrated by the Thrift Saving Plan, the personal accounts program covering US federal civil servants and the military. Standardized investment education and record keeping would greatly improve workers' financial literacy and understanding of their retirement saving options. With careful thought to plan design, cost concerns need not be an obstacle.

Conclusion

The main appeal of personal accounts is not that they would "solve" Social Security's financing problems. Rather, they provide workers with ownership of wealth, they allow people to invest according to their own risk preferences, and they are available in the event of divorce or premature death. Some workers will be better off by

having the chance to invest in stocks and earn higher expected returns; others who believe that risk-adjusted expected stock returns equal risk-adjusted bond returns would be neutral. On net, it is likely that a majority of workers would choose to invest in personal accounts given a choice, since they know that Social Security promises are highly uncertain in view of system financing shortfalls. Yet irrespective of whether personal accounts are adopted, Social Security reforms are needed that reduce system debt if future generations are to do better than the dismal returns projected from our current troubled system.

¹ Opinions herein are solely those of the author. This work draws on several studies including Geanakoplos, John, Olivia S. Mitchell, and Stephen Zeldes. "Social Security Money's Worth". In *Prospects for Social Security Reform*. Eds. O.S. Mitchell, R. Myers, and H. Young. Pension Research Council. Philadelphia, PA: University of Pennsylvania Press, 1999: 79-151; Geanakoplos, John, Olivia S. Mitchell, and Stephen Zeldes. "Would a Privatized Social Security System Really Pay a Higher Rate of Return?" In *Framing the Social Security Debate*. Eds. D. Arnold, M. Graetz, and A. Munnell. Brookings Institution, 1998:137-156; and the Interim and Final Reports of the President's Commission to Strengthen Social Security (www.csss.gov).

² Here I abstract from the Disability Insurance plan under Social Security.

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- Or call us at (734) 615-0422 and let us know you'd like to be put on the hard-copy newsletter mailing list.

Our newsletter is also available on-line as an Adobe Acrobat document. Please pass this information on to anyone who would be interested.

Mark your Calendars for the 4th Annual Conference of Retirement Research Consortium

May 30-31, 2002
National Press Club
Washington, DC

Information about this conference, including registration information, will be provided and updated as needed on the MRRC website: www.mrrc.isr.umich.edu or can be obtained by calling Patty Hall at (734) 615-0422.



Source: Library of Congress Web site
(<http://www.loc.gov>)

The 4th Annual Conference is being organized by the Michigan Retirement Research Center in cooperation with the Boston Center for Retirement Research.



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