University of Michigan Retirement Research Center

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Director's Corner

Regular Features

Inside This Issue

In its March 2005 report, entitled "Retirement Security: the Unfolding of a Predictable Surprise," the Social Security Advisory Board presents analysis, findings, and recommendations generated during a year of study. The Social Security Independence and Program Improvements Act of 1994 led to formation of the Board and established its charge for "analyzing the Nation's retirement and disability systems and making recommendations with respect to how the old-age survivors, and disability insurance program and the supplemental security income program, supported by other public and private systems, can most effectively ensure economic security."

The report underscores the importance of research, asserting that policymakers depend on research to "inform them of the likely consequences of policy changes." (In this regard, the report highlights the Retirement Research Consortium and commends SSA for establishing it.) The Board affirms the importance of the range of research topics the MRRC and the other RRC centers support: the effects of reform on saving; the relationship between Social Security and other government-sponsored income security programs; the distributional effects of policy change; behavioral economics; and microsimulation models. The report also recognizes the value of improving access to and usability of key datasets. Since its inception, the MRRC has provided support for a range of data projects including a secure facility at the University of Michigan where researches can analyze Social Security administrative records linked to Health and Retirement Study (HRS) data, a secure network (Virtual Private Network) that would allow researchers to analyze confidential data without having to leave their own research facilities, a user friendly version of the HRS (the RAND HRS), and a project that develops methods for dealing with data inconsistencies that arise in longitudinal surveys when questionnaires are improved and modified over time.

The "Retirement Security" report weighs in with sensible and nonpartisan recommendations. This issue of the MRRC newsletter summarizes some of my own thoughts on reform of Social Security. I find myself in full agreement with the Board on the importance of considering reform in a wide economic and social context. I hope that strengthening Social Security will be one aspect of a broad strategy of working to strengthen the economy's foundation for long-term stability and growth.

John Laitner

hn Laitner, Director MRRC

Comment

SOCIAL SECURITY SOLVENCY: A CRISIS?

by John Laitner

Executive Summary

Social Security has become a topic of national conversation; politicians and news media are widely discussing the need for, and possible shape of, Social Security reform. The basic factors leading to the necessity of policy change are evident: fertility has gradually declined and longevity increased; thus, the number of older Americans relative to those of working age has risen, and these trends render a pay-as-you-go pension system unable to continue to deliver benefits at previous levels of generosity without additional revenues. This brief first attempts to survey the backdrop of the present economic situation more broadly than just demographics. After setting a context in that way, it suggests a two-part answer to the question in its title. Finally, it briefly discusses the relation of one frequently mentioned possible reform, the introduction of so-called personal accounts, to Social Security's current difficulties.

Background

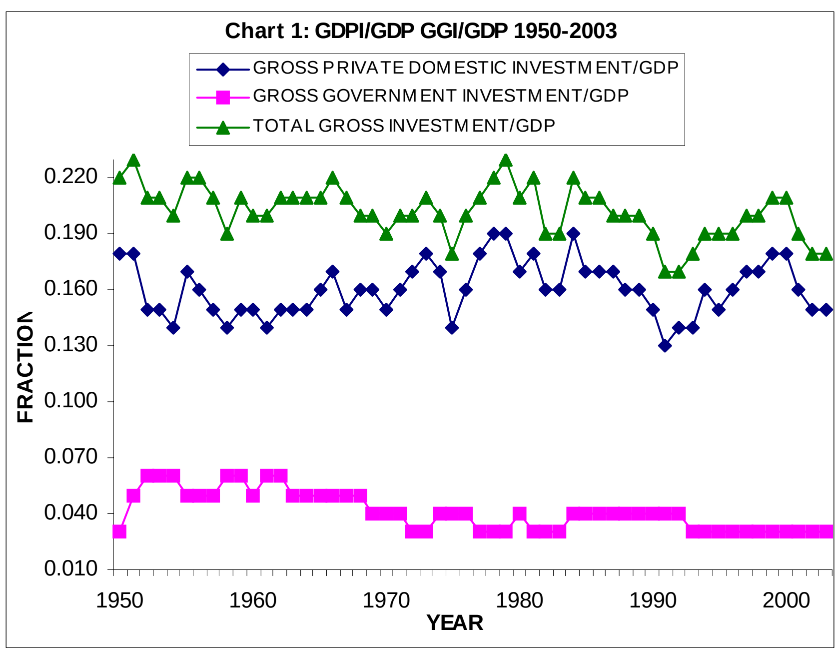
Advocates of reform often associate needs to change the Social Security system with deficiencies in U.S. saving behavior and/or with government budgetary problems in general. It is now widely known that the Social security system is approaching a time when revenues from the current level of payroll tax will not be sufficient to cover benefits owed. Less well known, perhaps, are facts about the national economy as a whole. As we continue to discuss reform options, it is important to keep this larger context in mind since it may influence specific policy choices.

Turning to the overall economy, output per worker – a good measure of the standard of living that the economy can deliver – depends primarily upon physical capital per worker, the state of technology, and so-called human capital (i.e., education, training, and experience) per worker. I focus here on the first. Domestic physical capital comes from domestic investment spending on the part of the private sector and the government. Investment, in turn, must be financed with saving.

Figure 1 shows that domestic investment as a share of total output (i.e., GDP) has fallen slightly over the last 50 years, from about 22 percent to about 20 percent. The entire decline, however, comes from a fall in government investment; private investment spending has remained the same. Perhaps building the national highway system and numerous public schools to handle the baby boom created special governmental investment needs in the post WWII years. On the private side, the picture seems quite stationary.

Since a dollar's worth of saving must finance each dollar of investment, total investment must equal total saving. Total saving is the sum of three components: domestic private saving (from businesses and households), government saving, and net foreign financial investment (the last consisting of saving on the part of foreigners that flows into U.S. capital markets and purchases U.S. assets). Chart 2 shows that domestic private saving as a share of GDP has trended down over the last 25 years in the U.S. Nevertheless, prior to that, private saving trended upward. In the end, perhaps surprisingly, domestic private saving remains almost exactly as large a fraction of GDP today as it was in 1950.

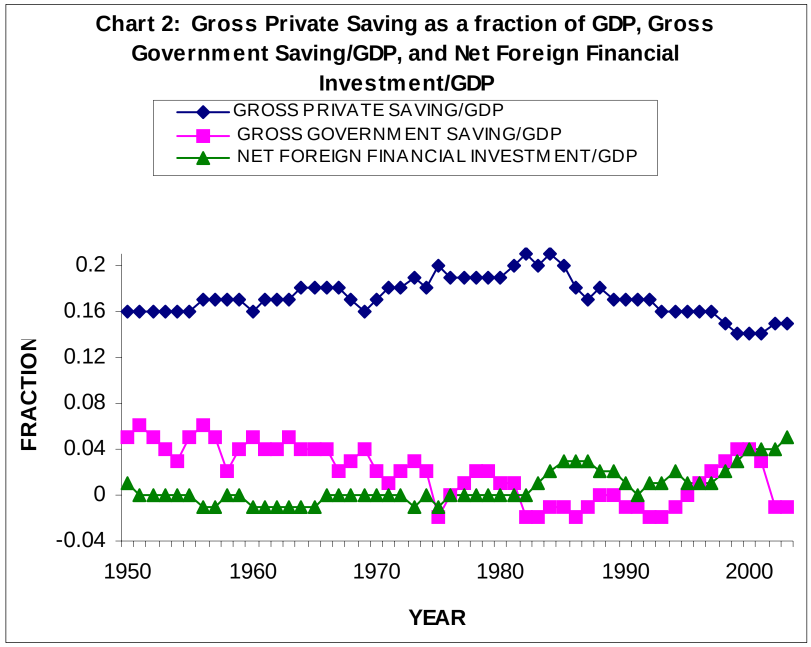
The chart shows, on the other hand, that government saving – the excess of tax revenue over current government spending on transfer payments and consumption



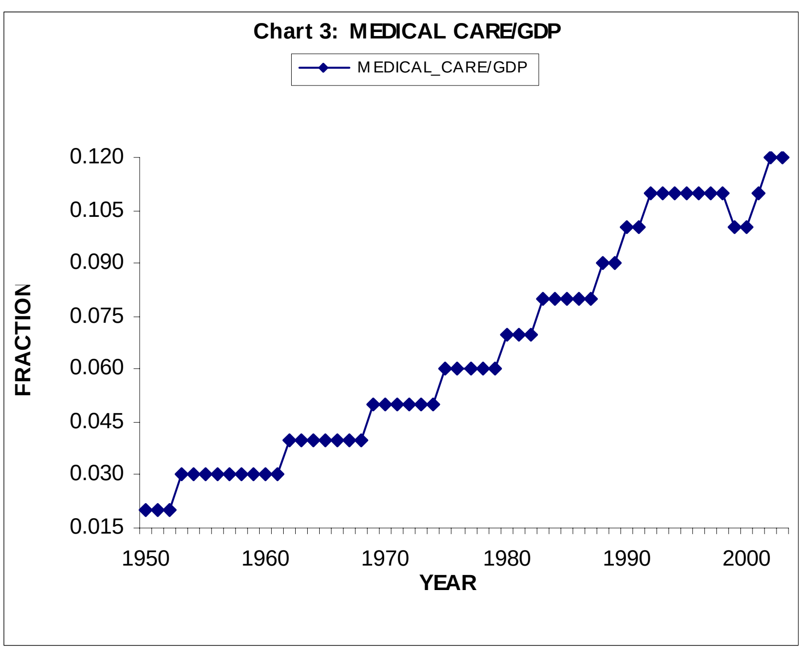
has trended downward, from a share of GDP of about 5 percent in 1950 to -1 percent recently. Since investment has not changed nearly as much, inflows of foreign saving (i.e., net foreign financial investment) must have made up the difference. Indeed, Chart 2 shows that inflows of foreign saving have risen, especially since 1970.

In sum, U.S. domestic investment in physical capital – in particular, privately owned physical capital – has proceeded at a steady long-term pace over the last five decades. The U.S. has, however, begun relying increasingly on foreign sources of financing for its investment. To the extent that foreigners accumulate U.S. government bonds through their financial investments, U.S. taxpayers will owe them interest in the future. To the extent that foreigners acquire private securities, future dividends, interest, and capital gains will accrue to them. One wonders as well whether foreign owners of U.S. businesses will want to hire Americans to top management positions or whether the U.S. will begin, in a sense, to lose control over a portion of its business sector.

As an aside, low government saving has led to increases in the Federal debt, the so-called national debt. The ratio of the Federal debt to the GDP was 1.18 in 1945, after enormous wartime spending; it steadily fell until about 1981, reaching a low of .33 in that year; but it has risen subsequently, reaching about .63 in 2003.



Finally, Chart 3 shows medical expenditures as a share of GDP. The share rose from under 3 percent in 1950 to 12 percent recently. The *Economic Report of the President 2004* (Chapter 6) projects that the Federal budget deficit, in the absence of corrective action, will expand by 2080 to 200 percent of the present budget's share of GDP. The three budgetary components that account for most of the problem are Medicare, Medicaid, and interest on the national debt. Federal medical spending is about as large as Social Security benefit payments now; the *Economic Report of the President 2004* projects that medical spending will be about twice as large as Social Security benefits by 2080. Large increases in medical spending have accompanied the decline in government saving in recent decades, and it is difficult to believe that government saving can be restored to previous levels without progress in limiting rates of increase in Medicare and Medicaid expenditures.



A Crisis?

It seems fair to say that the U.S. Social Security System faces a "serious" solvency problem in this century. It also seems fair to say that discussions of Social Security frequently advertise possibilities for increasing overall national saving as a key by-product of reform.

There are indeed close ties between Social Security and overall saving. On the one hand, the Social Security system surely reduces private incentives to save: e.g., I do not need to save as much for my own retirement if I can expect to receive Social Security benefits. On the other hand, the difference between Social Security tax receipts and Social Security benefit expenditures impacts government saving directly. Recently the latter effect has been to increase government saving. But, longer term the effect will be the opposite – until the system's solvency problems receive attention. If we want to think of Social Security as one element in the larger picture of government saving, that picture, in total, does, to this author, seem to be one of ``crisis'' – though, as we have seen, fixing Social Security's insolvency would only constitute a start at rectifying the full set of fiscal difficulties that we face.

Reform

Instituting a system of personal accounts is currently the most widely discussed direction for Social Security reform. This section speculates on the possible role of personal accounts in coping with Social Security's impending solvency problems and in alleviating the U.S. economy's growing dependence on foreign financing.

An earlier paper by the author, entitled ``Transition Paths and Social Security Reform,'' suggests that instituting personal accounts would, as a rough approximation, neither improve nor harm the solvency of the current Social Security system. The existing Social Security system is essentially an unfunded, or pay-as-you-go, defined benefit pension plan. In other words, the present system uses tax collections from workers to pay concurrent benefits to existing retirees. In this framework, any payroll tax collections that reform diverts to new personal accounts will have to be made up from other revenue sources if Social Security commitments to existing retirees are to be met.

Another way of thinking about this issue is as follows. The existing Social Security system, due to its unfunded nature, has zero net worth – it merely directs current flows of payroll tax revenues to current benefit payments to retirees. A functioning system of personal accounts, on the other hand, would have substantial net worth – namely, the sum of all personal account balances. To move from a system with zero net worth to one with positive net worth requires a transition period. If government borrows the money (by issuing new government debt) to pay retirees in the old system so that young people's payroll taxes can fund new personal accounts, after the transition period the increment to national debt will equal the assets in the new personal accounts. In other words, new national liabilities (i.e., new national debt) will counterbalance new assets (i.e., new personal account balances) so that in economic terms, the country's net worth position will remain the same as before.

This implies that there is no panacea for Social Security's looming solvency problems: we need to find new revenues, reduce benefits, or both. Personal accounts may well be desirable on their own merits, of course, but they do not in and of themselves fix the fiscal problems of the existing Social Security system.

One possible approach to reform would look first to the private sector. Private pensions are already undergoing a changeover from defined benefit plans to defined contribution plans. For example, U.S. Flow of Funds tables show that defined benefit plan assets were almost twice as large as those of defined contribution plans in 1985; by 1995, assets were about the same in each; and, by 2003, defined contribution plan assets were a third bigger. In a defined contribution plan, a worker has a personal pension account, he or she contributes to the account regularly, the account is typically portable, the worker typically has latitude over securities in which to invest the account's balance, and the balance plus interest belong to the worker at his or her retirement. Perhaps the regulatory environment can be set to help these plans to flourish. If private sector accounts are low cost, profitable, and widespread, they might in the not too distant future form a platform from which to launch Social Security personal accounts. In the meantime, since private--sector accounts are subject to rate of return risk, the existing Social Security system can provide workers with diversification.

An alternative approach would set a rapid and immediate transition to personal Social Security accounts. Perhaps the initiation of change would provide opportunities for arranging new sources of finance: individuals might be persuaded to increase their private saving to finance balances for the new accounts, or a temporary tax increase might ease the necessity for new government debt. Although the preceding paragraphs argue that as a first approximation, instituting personal accounts would not by itself lead to additional national wealth creation, other authors argue that the approximation is not perfect and that new benefits emerge that could be capitalized into temporary tax revenue sources. Details of the setup of the transition phase would be critical in determining whether new national wealth was accumulated or, indeed, whether existing solvency problems of Social Security were addressed.

Conclusion

Maintaining the present Social Security system is becoming more burdensome over time because of falling birthrates and increasing longevity. Instituting a system of Social Security personal accounts may not by itself solve existing inconsistencies between Social Security revenues and promised benefits. However, the transition period accompanying any large-scale policy change might offer opportunities to increase taxes temporarily or to limit benefits under the old system.

More generally, the Social Security system is only one component of the framework generating saving in the U.S. Over the last fifty years, private saving has held up surprisingly well (though the recent past is less reassuring). Government saving, on the other hand, has declined. That decline seems independent of Social Security, and the decline has led to substantial increases in the national debt. Reforming the Federal budget to restore balance should have the same high priority as restoring solvency to Social Security. This commentary suggests that reforming the U.S. system providing medical services may be a necessary part of any overall solution. It seems highly desirable to begin such reform as quickly as possible.

John Laitner is the director of the Michigan Retirement Research Center and professor of Economics at the University of Michigan.

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2005 Report of the Social Security Advisory Board Available

Over the past year, the Social Security Advisory Board has met with experts in the areas of pensions, savings, and health care and has produced a report that focuses on the national goal of economic security in retirement, how it has evolved, what are the major public and private elements that work together to achieve that goal, what are the gaps that need to be addressed, and what are the challenges that face these elements in the future. The report, "Retirement Security: the Unfolding of a Predictable Surprise," is available on-line at http://www.ssab.gov/NEW/documents/RetirementSecurityMarch11.pdf.

Members of the Social Security Advisory Board include Hal Daub, Chairman, Dorcas R. Hardy, Martha Keys, David Podoff, and Sylvester J. Schieber.

Corrected HRS/AHEAD data on Second Home Ownership and Equity Available

The AHEAD 1993 and 1995 and HRS 1996 second home ownership and equity correction data (Version 1.0) are now available. The background information regarding the problems in second home ownership and equity in the three data waves as well as correction strategies may be found in a memo released with the data at http://hrsonline.isr.umich.edu/news/sho_news.php?hfyle=soft002&xtyp=1

This data set is not approved for use with restricted files derived from Social Security Administration administrative data.

New MRRC Working Papers On-line

Below is a selection of abstracts from recently released MRRC working papers. Visit our website for full papers and other current papers. http://www.mrrc.isr.umich.edu.

Grasshoppers, Ants and Pre-Retirement Wealth: A Test of Permanent Income Consumers

Erik Hurst

This paper shows that households who enter retirement with low wealth consistently followed non-permanent income consumption rules during their working years. Using the Panel Study of Income Dynamics (PSID), a sample of pre-retired households is subsetted into households who save 'lower' than predicted and all other households. These households had similar opportunities to save; the average household in both these sub-samples are very similar along all observable income and demographic characteristics. Households in the low wealth residual sample had much larger declines in consumption upon retirement. Such a result is consistent with the household having inadequately planned for retirement. It is shown that these low pre-retirement wealth households had consumption growth that responded to predictable changes in income during their early working years as well as predictable income increases and declines, a result that is inconsistent with a liquidity constraints explanation. After ruling out other theories of consumption to explain these facts, it is concluded that households who entered retirement with lower than predicted wealth consistently followed near sighted consumption plans during their working lives.

Obesity, Disability, and Movement Onto the Disability Insurance Rolls

Richard V. Burkhauser and John Cawley

Between the early 1980s and 2002, both the prevalence of obesity and the number of beneficiaries of the Social Security Disability Insurance program doubled. We test whether these trends are related; specifically, we test whether obesity *causes* disability and movement onto the disability rolls.

Using two nationally representative data sets: the Panel Survey of Income Dynamics and the National Longitudinal Survey of Youth, 1979 Cohort, we find evidence that weight increases the probability of health-related work limitations and the probability of receiving disability related income. Our results suggest that the failure to treat obesity as endogenous leads to dramatic underestimates of the link between obesity and disability outcomes.

The Social Security Retirement Earnings Test, Retirement and Benefit Claiming

Alan L. Gustman and Thomas L. Steinmeier

This paper shows that from age 62 through full retirement age, the earnings test reduces the share working full time by about four percent of the married male population, which entails a reduction of about ten percent in the number of married males of that age at full time work. However, abolishing the earnings test would adversely affect the cash-flow of the system. If the earnings test were abolished between early and full retirement age, the share of married men claiming Social Security benefits would increase by about 10 percentage points, and average benefit payments would increase by about $1,800 per recipient, to be offset eventually by actuarially fair or better than fair reductions in benefit payouts throughout their 70s, 80s and 90s. One can increase the employment of older persons either by abolishing the earnings test or by increasing the early entitlement age under Social Security. A major difference on the funding side is that abolishing the earning test results in an earlier flow of benefit payments from Social Security, worsening the cash-flow problems of the system, while increasing the early entitlement age delays the flow of benefit payments from the system, improving its liquidity.

Using a Structural Retirement Model to Simulate the Effect of Changes to the OASDI and Medicare Programs

John Bound, Todd Stinebrickner, and Timothy Waidman

In this paper, we specify a dynamic programming model that addresses the interplay among health, financial resources, and the labor market behavior of men in the later part of their working lives. The model is estimated using data from the Health and Retirement Study. We use the model to simulate the impact on behavior of raising the normal retirement age, eliminating early retirement altogether and introducing universal health insurance.

Social Security Privatization with Elastic Labor Supply and Second-Best Taxes

Kent Smetters

This paper shows that many common methods of privatizing social security fail to reduce labor market distortions when taxes are second best, challenging a key reason to privatize. Ironically, providing "transition relief" to workers alive at the time of the reform, in an effort to protect their previous contributions, undercuts potential efficiency gains. Chile's reform -- the first major privatization that also served as a model for subsequent countries -- actually increased distortions. It is then shown that privatization with limited transition relief can reduce labor market distortions and produce gains to current and future generations without hurting initial retirees, i.e., a Pareto gain even with second-best taxes.

Measuring Social Security's Financial Problems

Jagadeesh Gokhale and Kent Smetters

According to the Social Security and Medicare Trustees, Social Security faces a future financial shortfall of $10.4 trillion in present value. This enormous imbalance has received little attention in public debates about Social Security. Instead, the media and policymakers continue to focus on the program's trust fund and several other ad-hoc measures that create a misleading impression of the size of Social Security's financial problem. Although the Social Security Trust Fund is not projected to be exhausted until 2042, Social Security's $10.4 trillion present value imbalance is accruing interest and will grow by $600 billion during 2004 alone. The current cash-flow federal budget, however, is biased against reforms that would improve Social Security's finances. As shown herein, a new federal accounting system would remove this bias.

Saving Shortfalls and Delayed Retirement

Andrew Au, Olivia S. Mitchell, John W.R. Phillips

Prior research has suggested that many older Americans have not saved enough to maintain consumption levels in old age. One way older persons might respond to inadequate savings would be to extend their work lives by delaying retirement. This paper examines evidence on this matter using the Health and Retirement Study. Among nonmarried persons, there is evidence that larger shortfalls do produce delayed retirement, though the effect is not quantitatively large. For married couples, pre-retirement wealth shortfalls do not appear to be significantly associated with delayed retirement. Evidently couples have other means of handling saving shortfalls.

Mark Your Calendars for the 7th Annual Conference of the Retirement Research Consortium August 11-12, 2005

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

The 7th Annual Conference is being organized by the Center for Retirement Research at Boston College, in cooperation with the Michigan Retirement Research Center, the Retirement Research Center of NBER, and the Social Security Administration.

New Version of Pension Calculator

An updated version of the HRS Pension Estimation Program is now available for download. The Pension Estimation Program is designed to estimate the pension entitlements held by respondents of the HRS, based on the plan formulas and benefit provisions obtained from the linked sample of pension providers.
http://hrsonline.isr.umich.edu/news/sho_news.php?hfyle=soft002&xtyp=1

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