

The future of Social Security

Social Security and the Stock Market: How the Pursuit of Market Magic Shapes the System. By Alicia H. Munnell and Steven A. Sass, Kalamazoo, MI, W.E. Upjohn Institute for Employment Research, 2006, 142 pp., \$18.00/paperback; \$40.00/cloth.

Many analysts recognize the need for some type of change to the Social Security program. What the change should be, however, is a matter of fierce debate. One of President George W. Bush's goals for his second term was the establishment within the Social Security system of "personal accounts," into which each individual in the system could invest as he or she chooses, including investing in the stock market. This idea never made it very far through Congress. But would investing a portion of the Social Security trust fund in potentially higher yielding equities aid in keeping the system afloat? If so, what are the available methods for making the investments? These are some of the subjects covered in this book by Alicia H. Munnell and Steven A. Sass, who are the director and associate director of the Center for Retirement Research at Boston College, respectively.

As the authors describe it, retirement security for the elderly prior to industrialization was not nearly as important a public policy issue as it is today. People usually either died young or worked as long as they were physically able to and then family members took care of them. The industrialization and urbanization that took place in the 19th century transformed the economics of aging. The first national old-age pension program began in Germany in 1889, and by the end of the 1930s almost all

of the industrialized nations had such programs. (The U.S. Social Security program was established in 1935, in the midst of the Great Depression.) The income Social Security provided to its recipients in its early years was miniscule, especially in comparison with what it provides today. The significant expansion of employer-provided pension plans that occurred after World War II was made possible primarily for three reasons. First, there was a rapid growth in the number of corporate employers that could afford such plans. Second, as the income tax grew to where many more people were subject to it, the tax advantages of pension plans became more important. Finally, labor unions became more powerful and were able to negotiate more generous pension plans, often through collective bargaining agreements.

In recent years, changes in the demographics of our society and in most employer pension plans have made the average American's retirement much less secure. Members of the "baby-boom" generation, Americans born between 1946 and 1964, are reaching retirement age. Because there are so many boomers and because the birth rate declined after 1964, the average number of workers "supporting" each retired person will fall to a very low level, far lower than was ever envisioned when Social Security began as part of the New Deal during the Franklin Delano Roosevelt administration. According to sources cited by the authors, current projections are that Social Security will not have enough money to pay full benefits after 2040, so payouts will have to be reduced.

Recognition of this increasingly difficult challenge is not new; in fact, the authors cite as one of Ronald Reagan's accomplishments legislation that cut benefits and increased revenues without significantly altering

the program's design. Marked changes have occurred among private-sector plans in the intervening 20 years, however. Specifically, there has been a transition from the traditional defined-benefits plan, which guaranteed retirees a stated level of income, to the now dominant defined-contribution plan (for example, 401 (k) individual retirement account savings plans), in which the level of retirement income is dependent on investments made prior to retirement. The result is that risk has been shifted from the employer to the employee.

In 1994, President Clinton established the Social Security Advisory Council. Its members spent 2 years studying ways to restore solvency to the Social Security program. Their conclusion was that the only way to solve the problem was to permit some funds to be invested in equities. They could not coalesce around a single approach, however, and instead came up with three. The Carve-Out Accounts approach is similar to President Bush's plan. It would cut the guaranteed benefits and put 5 percent of the existing payroll tax into "Personal Security Accounts." The Add-On Account approach would cut guaranteed benefits and then mandate an additional contribution to new individual retirement savings accounts equal to 1.6 percent of covered earnings. The Trust Fund Investment approach recommended modest changes to taxes and benefits, with a portion of the trust fund assets invested in equities.

The authors use three countries—The United Kingdom, Australia, and Canada—to illustrate the pros and cons of these approaches. The United Kingdom adopted a carve-out approach in 1979. According to the authors, "The carve-out approach as implemented in the United Kingdom produced sharply lower guaranteed social insurance benefits, the

privatization of much of the nation's diminished retirement income system, increased reliance on individual retirement income planning, and a major expansion of" their means-testing program. In addition, they feel, the overhead costs for maintaining individual accounts have been large. And the myopic view that many people had when trading present consumption for consumption in the future often led to too little saving, poor risk analysis, and the ultimate need for an extensive government safety net. These results are the exact opposite of what its proponents desired, and the authors caution that the United States could experience a similar outcome should this method be adopted.

Australia chose the Add-On individual accounts approach. Prior to the 1980s, Australia's public retirement program was a means-tested Age Pension program that had begun in 1908 and had been considerably expanded during the 1970s. Since the 1980s, Australia has started a Superannuation Guarantee program with contributions set at 9 percent of earnings, far larger than the 1.6-percent of earnings in the U.S. Add-On proposal. Fortunately, in the opinion of Munnell and Sass, the administrative costs for the individual accounts in Australia are much less than those in the U.K. because in most cases the individual contributions are invested collectively rather than sepa-

rately. Unfortunately, in their opinion, the means-testing of the Age Pension program seems to both discourage people from working and saving and encourage them to retire early. Although the Superannuation Guarantee program entails considerable risk, the authors feel that the Age Pension program in Australia "has and will remain critically important, both as the primary source of old-age income and as insurance against adverse financial shocks."

Canada adopted a Trust Fund Investment approach in 1997. Previously, Canada's public retirement program consisted of three parts: Old Age Security, a flat payment to all long-term residents paid out of general revenues; the Guaranteed Income Supplement, an income-tested benefit also funded out of general revenues; and the Canada/Quebec Pension Plan, funded by a payroll tax on earnings. The 1997 reform increased the Canada/Quebec Pension Plan payroll tax to pre-fund a program that invests in equities. This was not done through individual accounts but through a centrally managed trust fund, thereby significantly reducing the administrative costs and pooling the investment and mortality risks far more effectively than either of the other two approaches. The authors do state the following caveat: "The great fear [with this approach] is that the

government would use the trust fund as an instrument for advancing public policy or the policy of the politicians who happen to be in power." Fortunately, Canada was able to devise and implement their program in such a way that this has not been a problem. Sass and Munnell recommend the Canadian Trust Fund approach for the United States if our executive and legislative branches can eventually come to an agreement about investing some of the Social Security funds in the stock market.

Although brief—it is only 142 pages in length—this book provides important information on the public and employer-related retirement programs for the United States, as well as the United Kingdom, Australia, and Canada. The subject matter is rather complex, as the intended audience is probably either those who work in the pension field or those who at least have a working knowledge of it. The general public would probably find it much easier reading if personal examples of citizens of these nations with descriptions of the benefits they are receiving had been included.

—Ronald Johnson

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