



# Social Security Reform: Alternative Approaches

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# Agenda

**Root Causes**

**Progressive Indexing**

**Other Solutions**

**Personal Accounts**

## U.S. Demographic Trends

**1950:** 6.46 Workers supporting each retiree

**2000:** 4.48 Workers supporting each retiree

**2030:** 2.46 Workers supporting each retiree

Source: *World Population Prospects*, the 2000 Revision, Volume II, U.N. Publication No. E. 01. XII.9 (2001)

# Government Accounting Issues

- Cash flow accounting
  - Annual revenues vs. annual benefit payment
  - Surplus of \$165.4 billion in 2002
- Pension accrual accounting
  - \$12.6 trillion in unfunded accrued liabilities in 2002
  - 75-year deficit with a present value of \$3.8 trillion (today)
- Key dates
  - Budget squeeze in 2017
  - Benefit default in 2041

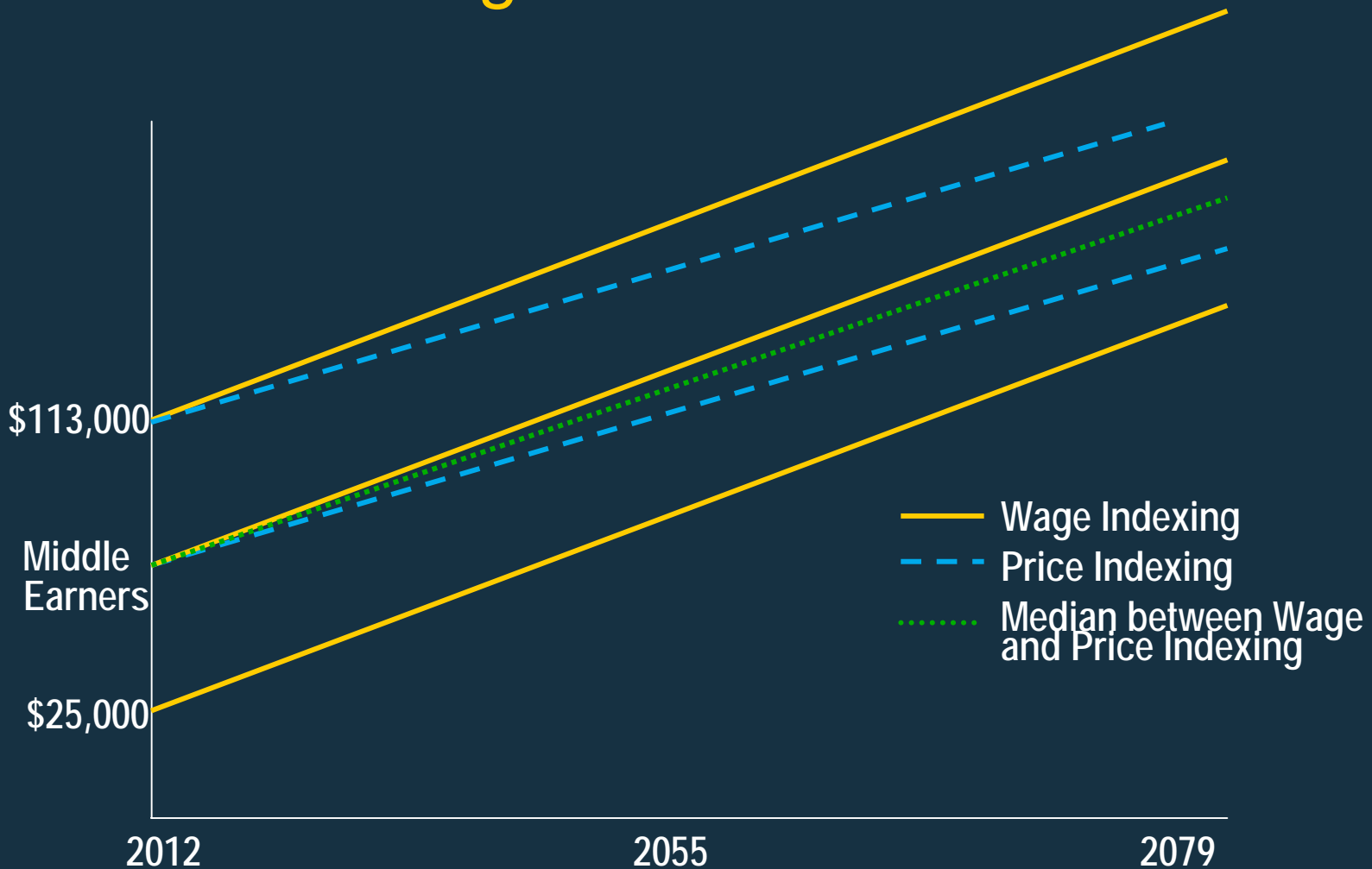
# Price vs. Wage Indexing

- Price indexing of benefits
  - After retirement (cost-of-living adjustments)
- Wage indexing of initial benefits
  - Increase career earnings by wage increases in whole economy over career
- Wages growing faster than prices
  - 1.1% per year on average

# Total Move from Wage to Price Indexing

- Pro:
  - Dramatic reduction in long-term deficit
- Con:
  - Reduce percentage of wages replaced by Social Security benefits (replacement ratio)
- Who has private retirement benefits [401(k)s and IRAs] to bolster replacement ratio?
  - Over \$50 billion in annual tax benefits
  - Go mainly to high and medium earners

# Slower Benefit Growth for Middle and High Earners



## Impact on Median-Wager Retiring at Age 65 (\$47,000 per year in 2012)

	Annual Benefits (2004 Dollars)	Increase in Purchasing Power	Replacement Ratio from Social Security
2005 Current Schedule	\$14,384	—	41%
2045 Current Schedule	\$19,544	51%	36%
2045 Progressive Indexing	\$16,417	21%	30%
2045 Payable Benefits	\$14,267	None	26%

# Increase Normal Retirement Age (NRA)

- NRA already will move back to
  - Age 66 by 2011
  - Age 67 by 2027
- NRA to age 69 in 2040, and to age 70 in 2050
  - Problems for low-wage workers with physical labor
  - Difficulty for elderly getting full-time jobs
- People want to retire earlier – male labor force participation at age 62\*
  - 1960: 79.8%
  - 1995: 51.3%

\*Source: Professor Joseph F. Quinn, "Changing Retirement Trends And Their Impact On Elderly Entitlement Programs," in Policies for An Aging Society (eds. Stuart Altman and David Shactman)

## Raise Payroll Taxes

- Currently 12.4% (6.2% employee) of first \$90,000 in wages
- Raise maximum FICA taxable earnings from \$90,000 to \$150,000 or \$200,000
- Incremental surtax of 2.9% (1.45% employee) on all wages above maximum FICA taxable earnings

## Government Investing in Stock Market

- Example of conflicting goals
  - “Maximizing returns without undue risk”
  - “Avoid prejudice to New Zealand’s reputation as a responsible member of the world community”
- Restrictions on investments in alcohol, gambling, tobacco, etc.
- World Bank 2001 study shows lower returns from government investing than private pension funds

# Link to Personal Accounts (PAs)

- “Magic Bullet”: unrealistic
- Political “sweetener” for legislative package
- Quid pro quo for slower growing Social Security benefits

# Types of PAs

- Carve-out accounts
  - Modest portion of 12.4%
  - Offset to traditional benefits
- Add-on accounts (IRAs)
  - Lift ceiling on Roth IRAs
  - Enhance low-income tax credits for IRAs

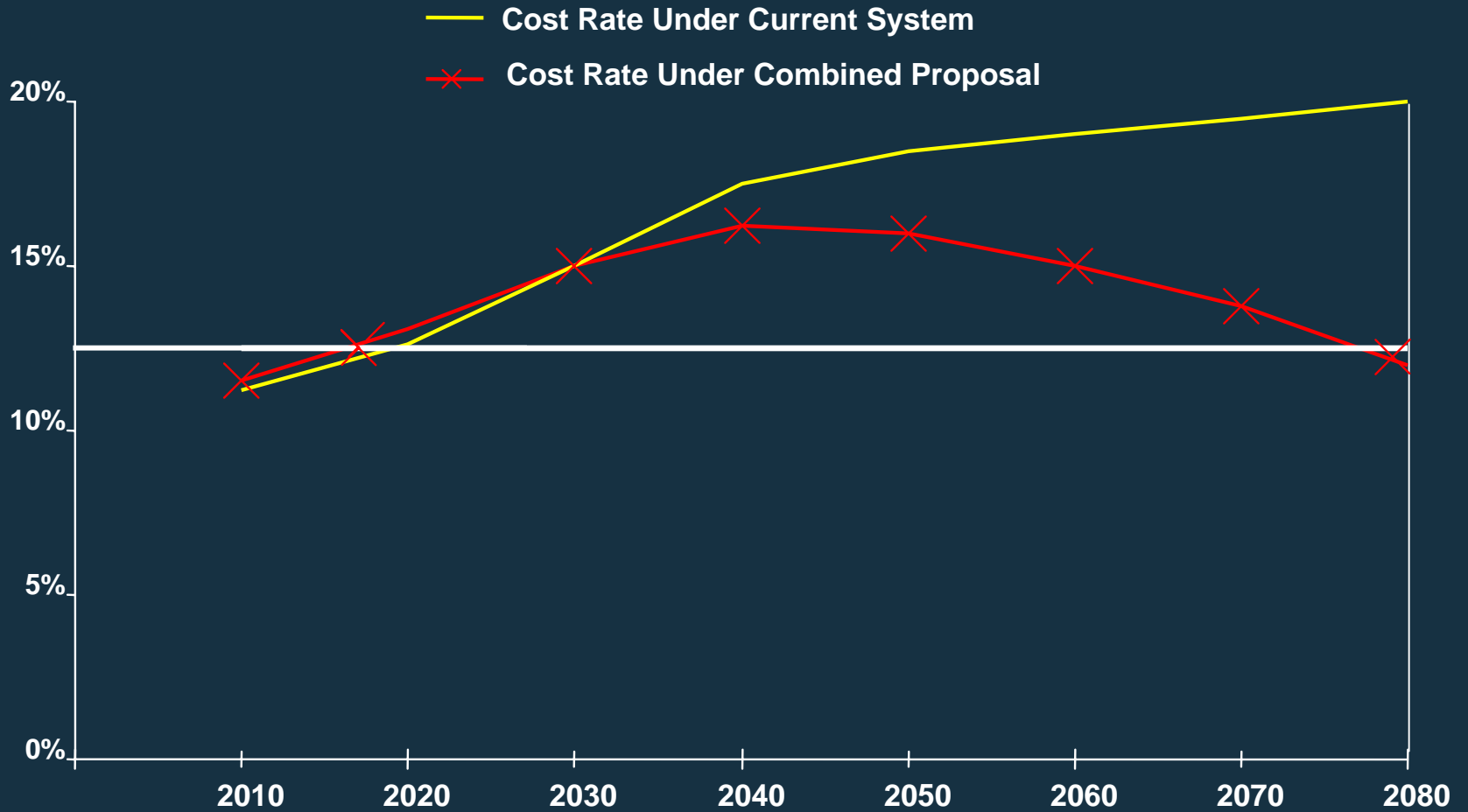
# Administration and Investments

- Not follow IRA model
- Piggyback on current system for employers sending FICA taxes to the IRS
- Allocations to investment pools
  - Trustees of Federal Thrift Plan
  - Limited array of index funds

# Risks: Volatility of Returns

- Year-to-year volatility vs. relatively stable returns over 30-40 years
- Down stock years matched by up bond years (12 out of 13 years from 1950 to 2004)
- End-game issues
  - If retired in 2002, worker would have relatively small PA
  - Solution: starting 5 years before anticipated retirement date, scale down equity to 20% of portfolio at retirement

# Income and Cost Rates



## Conclusions

- Broad view of government support for retirement income
  - Private retirement plans
  - Social Security
- Progressive indexing can be combined with other solvency approaches and different types of PAs
- Window of opportunity for Social Security
  - Second-term president
  - Before Baby Boomers retire