Financial Planning

With Social Security facing a long-term imbalance and Medicare due to run out of money within several years, some reform is inevitable. A look at the proposals.

Coming, Ready or Not: Reform for Medicare and Social Security

By Michael E. Leonetti

It's generally believed that baby boomers won't see a dime's worth of Social Security benefits. Most young people assume that by the time they are old, the program will be long gone.

Social Security truly needs repairs, as evidenced by the report released in mid-January by the bipartisan Social Security Advisory Council. However, the report shows a system in better shape than most people think, and with adjustments made soon, baby boomer retirements as they relate to Social Security could be manageable.

Reforming Social Security is sure to inspire as large a debate as the attempt to reform healthcare did in President Clinton's first term. But the one fact all sides agree on is that the program is in a long-term imbalance and needs to be addressed. The issues involved affect almost everyone, and it is worthwhile spending a little time to examine the various proposals.

Social Security: The Problem

Social Security was created to serve two goals: to create individual equity by tying benefits to work and contributions, and to improve social adequacy by meeting larger social goals like reducing poverty among the elderly and creating a higher standard of living for lower-income workers in their retirement.

The system we have now serves as something of a contributory social insurance. Pooled resources are used to assist the elderly, disabled, and survivors of deceased workers. Today, nearly one in five (approximately 44 million) Americans and their families are receiving Social Security benefits.

Nonetheless, Social Security currently collects more in taxes than it pays out in benefits. The excess—the trust fund—is invested in special U.S. Treasury bonds, which last year paid an average of 7.6%.

The trust fund is expected to grow until around 2019, when changing demographics creates severe problems. As life expectancies increase, birth rates drop and a greater percentage of Americans age 65 or older increases, the worker-to-beneficiary ratio has steadily dropped—today it is 3.2 workers per beneficiary, compared to 16.5 workers per beneficiary when the program started. By 2020, it is estimated that there will be only two workers supporting each benefit recipient.

At that point in time, the program will pay more in benefits than it collects, and to meet its obligations, Social Security will start cashing in its Treasury bonds. As a point to note, Medicare has been tapping its trust fund since 1995.

When Social Security starts cashing in its Treasury bonds, the U.S. government, which issued the Treasury bonds, will have to come up with the cash to redeem the bonds. It is unclear how the government will do this; options include spending cuts, tax hikes, or borrowing money in the open market.

According to most studies, around the year 2029 or 2030, the money in the trust fund will be depleted. But this doesn't mean the Social Security system totally collapses. According to projections, revenues from the payroll tax would be sufficient to pay 75% of the Social Security benefits, but needless to say there would still be a negative impact on retirees and workers at that time.

Faced with the reality of changing demographics and a diminishing revenue base, change for the system looms ahead. Interestingly, the proposals generated by the advisory council call for at least a partial privatization of Social Security. And some pension experts feel that the country would be better served if the system were to be completely privatized.

One Solution: Full Privatization

If complete privatization were to happen, individuals would fund their own retirement through a mandatory savings and investment program; under this scenario, the worker-beneficiary ratio would no longer be part of the equation.

Chile is often cited as a model for such a move. In 1980, the Chilean government moved from a government-run pay-as-you-go system to a privately

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administered system of pension savings accounts. Under this system, 10% of a worker's wages are automatically deposited by employers into the individual's account each month. Workers then have the option of contributing an additional 10% each month on their own before taxes are assessed. Neither employers nor employees pay a Social Security tax to the state.

While Chile's arrangement seems to be a success for its workers, there would be several problems in administering this type of system here in the United States. First, the transition to such a system is costly. In Chile's case, the government was able to cover the cost of the transition to the new system with general surplus revenues, but the U.S. does not have the federal surplus to cover those costs. Additionally, there are fairly high administrative costs associated with the private Chilean system—15% compared to just 1% spent under our current system.

In any event, it will be interesting to see if this idea moves forward at all and is added as an option for consideration by the council.

Advisory Council Proposals

The advisory council came up with three primary proposals to correct the shortfall; here is a brief summary:

Maintain Benefits: The first of the three proposals aims to preserve the current system as much as possible. It is supported by six of the 13 members of the advisory council. This plan would stick to the schedule for the increase in retirement age as implemented in the 1983 reform. The payroll tax would increase by 0.8% for both the employee and the employer, increasing the total per-worker payroll tax by 1.6%. In addition, up to 40% of the trust fund's assets could be invested in marketable securities by 2014.

Critics of this plan worry that this is not enough of a fix, and that another shortfall will develop within 10 years. Proponents point out that it is the only plan that will not affect the budget deficit, and that it leaves intact the system now successfully contributing to the retirements of more than 44 million people.

Individual Accounts Reform Plan: The second compromise plan is supported by the chairman of the council and one other member. It would create individual IRAs for workers, but the government would retain custody of the accounts and offer workers a limited menu of investment choices along the lines of the Federal Thrift Plan. These investments would include private market securities. The payroll tax would be raised to 14% of pay from the current 12.4%.

Personal Security Accounts: The third, and most radical, of the council's plans is supported by five of its members. This plan would split the Social Security system into a defined-benefit portion covering minimum benefits and a defined-contribution portion. The plan would set aside 40% of the payroll tax to cover the defined benefit portion of the plan, which would pay out a minimum flat benefit to all participants. Another 20% would be used to fund the Disability and Survivor's Insurance Program. The remaining 40% would be for the defined-contribution portion, and the money would be placed in an account owned by the worker. Workers would be able to invest these accounts, much like 401(k)s, in any approved investment. Like 401(k)s, the value of the individual account will depend on the final accumulated value of the worker's investments.

Critics of this plan point to the fact that it introduces the unknowns of market performance to individuals for the first time. Additionally, it requires a special payroll tax of 1.52% for the next 70 years to fund the transition from a pay-as-you-go plan.

All of these plans share one common characteristic: They leave some of Social Security's assets to be invested in marketable securities. The debate seems to be over who directs and retains custody of the assets.

Details of the council's proposals are outlined in Table 1.

Probable Reform: Medicare

While much of the discussion in this country is centered around Social Security reform, the opening round of the entitlement fights will probably be over Medicare, which is due to run out of money within four years. Social Security is a few decades further away from insolvency, but will also need to be addressed now before it is too difficult, and possibly too late, to effect a less painless, lasting change.

In August, President Clinton stated that he intends to re-engineer both of these programs during his second term. As we know, first terms are about reelection, and second terms are about history. Through the bipartisan council, the president hopes to avoid being the one leading an unpopular parade to cut retirees' benefits or raise taxes. However, we are kidding ourselves if we believe this is not as much a political issue as it is a financial one. How long will it take Republicans, still smarting from election-year losses that they attribute partly to the Democrats' mediscare ads, to join the president?

The first step for the president is a plan to keep Medicare from going bankrupt. The program's hospital insurance fund, known as Medicare Part A, pays for inpatient hospital care for all Americans over age 65, as well as some home healthcare, skilled nursing home care, and hospice care. It spent some $4 billion more in fiscal 1996 than it collected in payroll taxes. Again, if Congress fails to act, the Congressional Budget Office predicts the Medicare Part A trust fund will run out of money by 2001.

The other half of Medicare, Part B, pays for 80% of doctor and other outpatient bills from general tax revenues and retiree premiums. It, too, is out of control. Part B expenditures have almost tripled over the past decade. All in all, the Congressional Budget Office estimates that the Medicare tab will reach $463 billion a year by 2006 and take up 18% of the federal budget—more than the government now spends on education, crime, and defense combined. While the president has taken some action, he knows he needs to take further steps.

Here, look for a relatively painless short-term fix designed to postpone

Table 1.
Social Security Advisory Council: A Comparison of the Proposals

	Maintenance of Benefits Reform Plan	Individual Accounts Reform Plan	Personal Security Accounts Plan
Type of plan	Defined-benefit	Defined-benefit and defined-contribution	Phase out half of existing defined-benefit system; replace it with a defined-contribution system. Remaining defined-benefit part of system is restructured to provide a flat benefit for all participants.
Private market investment?	Yes	Yes	Yes
Who invests?	Federal government	Individuals	Individuals or their designated broker or financial institution
Individual accounts?	No	Yes, called individual accounts	Yes, called personal savings accounts
Individual participation?	None	Mandatory	Mandatory for workers under age 55 in 1998
Where is individual account held?	Not applicable	Accounts are held by the federal government but are separate from federal assets and are not used in calculating the federal debt.	In private institutions designated by workers
Use FICA revenue for investment?	Yes; invest part of trust fund accumulations that would otherwise be invested in U.S. Treasury bonds; gradual investment until 40% of accumulations are in private market securities by 2014.	No	Yes; invest five percentage points of the non-Medicare FICA rate (12.4%), paid only by the employee (remaining 7.4% used to finance the flat benefit, as well benefits).
Increase payroll contributions?	Yes, 0.8% on employers and employees (1.6% additional tax overall) beginning in 2045; non-Medicare FICA would then equal 14.0% total.	Yes, 1.6% on employees in 1998. Defined-benefit part remains financed by 12.4% FICA; total FICA in 1998 would be 14.0%	Yes, by 1.52% on employers and then employees for 70 years, beginning in 1998 to help finance transition.
Tax treatment of individual account benefits	Not applicable	Employee contributions are aftertax, while distributions are free of federal income taxes.	Individuals' contribution to personal savings accounts are aftertax, so distributions are tax-free.
Investment rules	Corporate bonds and equity index funds	Based on Federal Thrift Savings Plan —choose from a list of index funds administered by the Social Security Administration.	Assets are invested at the discretion of the worker, but subject to regulations restricting them to retirement purposes and to widely-held investments.
Increase normal retirement age faster than change mandated by the 1983 amendment (age 67 by 2027)?	No	Yes, gradually increase the normal retirement age by two months annually beginning in 2000 until age 67 for those reaching age 62 by 2001; index to longevity thereafter; full-benefit normal retirement age equals age 69 by 2059.	Yes, gradually increase normal retirement age by two months annually, beginning in 2000 until age 67 for those reaching age 62 by 2001; index to longevity thereafter; this rate of increase to be reviewed every 10 years by Congress.
Minimum guaranteed benefit to all who participate?	No change from current law.	No change from current law.	Yes, for workers participating for 35 years, equivalent to $410 per month in benefits (1996 dollars) from Tier 1 (defined-benefit part), indexed by growth of average wages; a smaller minimum benefit for workers participating fewer years; people with only 10 years participation get one-half of full-career worker's benefits.

Source: The Institute of Management and Adminstrations Report on Defined Contribution Plan Investing.

insolvency for a short time. The president will likely try to generate savings mostly by squeezing reimbursements to doctors, hospitals, and other healthcare providers. Congress and the president are also likely to add some consumer protections to make the managed care system seem less fearsome to the elderly.

Once the quick fixes are in place, the president would like to see a Medicare Commission tackle the serious long-term reforms. Most believe that insuring the program's solvency over the next 75 years would require truly painful moves—for instance, more than doubling the current 2.9% payroll tax immediately, thereby pushing up the average worker's tax bill from $735 to $1,880 a year. The point is, getting anywhere will require a hefty combination of benefits cuts and revenue increases. In addition to further healthcare provider cuts, some likely recommended changes are as follows:

1. *Raise retiree costs:* After 1998, annual increases to Medicare Part B premiums are scheduled to be limited to the cost-of-living adjustment for Social Security, which is running slightly less than 3%. It's likely that this cap would be scrapped and the premiums would be kept at 25% of the program's cost. It is also likely that upper-income retirees may well end up paying higher Medicare premiums than others before the end of the president's second term.

2. *Increase choice*: Despite the move toward managed care, Medicare continues to offer primarily traditional fee-for-service coverage and HMOs. Here we envision the government giving retirees a full range of choices and prices, similar to those enjoyed by workers in big companies.

3. *Hike payroll taxes*: No one likes the "T" word but Medicare tax increases will almost certainly occur. Historically, whenever Social Security or Medicare have reached a crisis point, a payroll tax increase has been part of the solution.

Social Security

The Social Security system is not in immediate peril, which may be why elderly advocacy groups as well as powerful labor unions support the status quo. However, pressure from younger people—and Wall Street—make reform inevitable. The odds are good that the eligibility age for collecting full Social Security retirement benefits will be increased. While this age is already slated to stretch from 65 to 67 in 2027, a commission might, for example, raise it to 68 as early as 2017, affecting people now 47 or younger. There is also some support in Congress for reducing the growth of Social Security benefits by shaving a half point or so off the Consumer Price Index, on which the annual cost-of-living adjustments are based.

Yet, Social Security's main reform issue seems to be privatization, a change already popular among younger people. To appease baby boomers and Generation X'ers who think Social Security won't be around for as long as they will, there is a push to let workers divert part of their Social Security payroll tax into their individual retirement accounts or tax-deferred mutual funds. While the president remains wary of privatization, a top Clinton adviser says there is a slightly better than 50/50 chance there will be a serious run at this type of reform sometime in the next couple of years.

What to Do

While no one knows what the system will look like in 2029 and beyond, there is a good chance it will still be around. It would be both useful and interesting to keep a close eye on the evolution and the eventual resolution of this issue. It will undoubtedly have a tremendous impact on your personal finances. However, no matter which scenario occurs, most individuals should adopt a conservative attitude and rely more on individual savings versus depending upon government programs.

Here are some steps you can take now:

• ***Save more:*** Rethink your savings and force yourself to acknowledge how big a retirement gap you may face in the future.

• ***Invest more aggressively:*** While there may be more stock market investors than ever before, few of them invest aggressively enough. Unless you are within a few years of retiring, or are currently retired, saving for your retirement is a long-term goal, and when you are dealing with the long term, most of your money should be invested in stocks. Proper diversification can go a long way toward building a larger nest egg while minimizing the day-to-day volatility.

• ***Prepare for a post-retirement career:*** With much longer and healthier lives on the horizon, most people will want to work beyond age 65. You may want to continue doing precisely what you did before retirement, but with fewer hours and less physical demands. Or, you may want to shift to another career.

• ***Plan for a long, healthy life:*** When Social Security was created in the 1930s, the average person of age 65 could expect to live only 12.5 years more. Today, someone age 65 can expect to live another 17 years. You should expect to budget more of your own money for health coverage. Additionally, it would be wise to investigate long-term care insurance to pay for nursing home stays when you are older if this is necessary. Finally, take care of yourself. The evidence is overwhelming that people who take care of themselves have lower healthcare costs.

Summing It All Up

In the end, the importance of these reforms is due to the importance of the programs in almost every individual's retirement years.

If you can lessen the importance of these programs to your own financial well-being, you will have more control over your own life and be less dependent upon others. This, in turn, should provide you with a greater peace of mind, and in the end, isn't that the most important thing for those retirement years?