



AMERICANS FOR TAX REFORM

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1920 L STREET, N.W. - SUITE 200 - WASHINGTON, D.C. 20036 - 202-785-0266 - [HTTP://WWW.ATR.ORG](http://www.ATR.org)

Social Security Personal Account Reform Alternatives

By
Peter Ferrara
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EXECUTIVE SUMMARY

Some personal account supporters are insisting on proposals involving small personal accounts of about 2 percent of wages, with very large reductions in the long-term growth of Social Security benefits, and even in some cases tax increases, to close the long-term Social Security financing gap. But a strong, substantial, personal account option will unwind the long-term Social Security deficits, and eliminate the program's unfunded liabilities, with nothing more than the positive features of personal accounts.

Small accounts embedded in a package of large benefit cuts will just take the focus off of the positive features of personal accounts, and short circuit the developing political success of a personal account option. Such proposals minimize the positive features and effects of personal accounts, and achievement of the long-term goals of personal account reformers. The grassroots populist appeal of the reform effort would be nullified, leaving reformers ultimately powerless in Washington.

Some have proposed achieving bigger accounts by placing essentially Social Security trust fund bonds in the accounts, which could not be sold by the worker to invest in other vehicles, and would pay only what Social Security would have paid at retirement. Such bonds do not allow larger personal accounts, but to the extent used just continue the current pay-as-you-go Social Security system under a personal account front.

President Bush should use his strong political clout now to work for a substantial, progressive, personal account allowing workers to invest 5 to 6 percentage points of the

payroll tax, with more for lower-income workers, and no benefit cuts. Such a proposal will completely solve the entire scope of Social Security's problems and provide overwhelming long-term benefits to working people across the board and the nation as a whole.

Peter Ferrara is Director of the International Center for Law and Economics, President of the Virginia Club for Growth, and a Senior Policy Advisor to Americans for Tax Reform on Social Security.

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Introduction

Some supporters of personal accounts are advancing proposals involving small personal accounts, which would allow workers to shift only about 2 percentage points of the payroll tax to the account. The proposals then include as well very large reductions in the long-term growth of Social Security benefits, and even in some cases tax increases, to close the Social Security financing gap more quickly.

An example of this approach is the legislation introduced by Reps. Jim Kolbe (R-Ariz.) and Charles Stenholm (D-Texas). The proposal includes basically a 2 percent personal account option. But it also includes changing the Social Security benefit formulas to substantially reduce long-term growth in Social Security benefits, delaying the retirement age under the program more rapidly, and reducing the program's cost-of-living adjustments. The proposal would also raise taxes. It would reduce the automatic indexing of income tax brackets under current law, which would raise income taxes. It would also raise payroll taxes by increasing the maximum annual income subject to Social Security taxes.

The logic behind this approach was recently explained to me by one of the staffers who helped to develop the Kolbe-Stenholm bill, and who thinks that bill should now be the model for reform. She said that personal account reform proposals "would be more popular the smaller the personal accounts and the larger the Social Security benefit cuts." She also said, "We will never get any Democrats to go along with a personal account reform plan unless it includes lots of benefit cuts." This staffer is now at the center of discussions regarding new personal account reform bills.

Another example of this approach is a proposal popular with some within the Bush administration. That proposal would allow workers to shift an average of 2.4 percentage points into the personal account (4 percent of wages up to a maximum of \$1,000 a year). It would then also change the calculation of future Social Security benefits so that they would grow at the rate of inflation over time (price indexing) instead of growing along with wages while the worker is still working (wage indexing).

THE DEAD END OF BENEFIT CUTS

Over the long run, this simple change from wage indexing to price indexing would produce very large reductions in the growth of Social Security benefits, almost enough to close the entire Social Security financing gap by itself. Ronald Reagan's Office of Management and Budget (OMB) Chief David Stockman in fact proposed a similar reform change early in the Reagan presidency. The Washington Post headline on it said, "Reagan to Propose 30% Cut in Social Security Benefits." The Senate famously voted 96-0 on a resolution asking the president to not even send the proposal to Congress.

One of the positive features of personal accounts is that the accounts alone, if they are sufficiently large, would ultimately eliminate the long-term Social Security financing gaps without cutting Social Security benefits or raising taxes. Indeed, if the reform is done right, in the end workers would have higher retirement benefits and lower taxes.

But the primary focus of personal account reform was never closing the long-term Social Security deficit, though that was always expected to result from the reform. The primary focus was the positive features of personal accounts – personal ownership and control of retirement funds, expanded freedom of choice, better benefits for working people across the board, greatly broadened ownership of wealth and capital, increased economic growth with better jobs and higher wages, etc. The fundamental philosophical goal of the reformers was to shift away from dependence on government and public taxes and spending, towards reliance on real, personal savings and investment.

What has brought about all the favorable poll results and celebrated election victories on personal accounts has been these positive, populist features, not Social Security benefit cuts, or tax increases, to close the long-term Social Security deficit. These extraneous, negative elements are highly unpopular in all polls, and are always disastrous on Election Day.

A strong, substantial personal account option will unwind the long-term Social Security deficits, and eliminate the program's unfunded liabilities, with nothing more than the positive features of personal accounts. As the years go by, workers will be retiring relying more and more on the real savings and investment in the accounts for their benefits, and less and less on the old Social Security framework. This process

would sharply reduce the benefit obligations of the old system, reducing the program's deficits and unfunded liabilities.

Assuming that almost all workers ultimately exercise the personal account option, eventually we would reach the point where virtually all workers are relying on personal accounts for their retirement benefits in place of the old Social Security framework. At that point, the old Social Security system would bear little or no benefit obligations, and there would consequently be no deficit or unfunded liability of any consequence in that old system.

So what sense does it make to add additional, unpopular Social Security benefit reductions that undermine the whole reform effort? That would just remove the focus on the personal accounts and their positive features. Opponents of personal accounts would focus their fire on the benefit reductions, and blame them on the accounts. The effect of the long-term benefit reductions would be grossly exaggerated. Why hand opponents such a hook to stop reform altogether?

Moreover, for the slim Republican majorities on Capitol Hill to advance these long-term benefit reductions with little or no bipartisan support would be political suicide. Every time that has been tried by either party, Republican or Democrat, the political results have been disastrous.

For example, in a dramatic episode in 1986, Republicans wheel chaired then-Sen. Pete Wilson (Calif.) into the Senate Chamber from his hospital bed where he was recovering from recent surgery. He then cast the deciding party line vote for a Republican budget plan that slightly reduced Social Security cost-of-living adjustments (COLAs). The COLA adjustment, however, was killed in the Democrat-controlled house. In the 1986 election, Democrats pounded away at Republicans who had voted for the COLA adjustment. When the votes were counted in November, the Republicans lost eight seats and their Senate majority -- falling to 45 seats.

But it works both ways. In 1993, the Democrats controlling both houses of Congress pushed through a budget plan on a party line vote that sharply increased income taxes on Social Security benefits. In 1994, of course, the Democrats lost both houses of Congress in a truly historic electoral defeat.

Sure, there were many other factors in both these elections. But still the past political experience for those who have flown in the face of Social Security populism on a party line vote is not good.

As a result, it would be a tragic mistake to ask President Bush to campaign for reelection in 2004 on a plan that includes shifting from wage indexing to price indexing, massively reducing future Social Security benefits. Those who insist such major benefit cuts must be included in any personal account plan are just killing the hope that the president will campaign on personal accounts as the centerpiece of his domestic agenda in next year's elections.

In addition, those who insist on including major benefit reductions to close the long-term Social Security deficit are just inviting tax increases as well. For Democrats and liberals will rightly ask when was it ever decided that the entire Social Security deficit was to be eliminated by benefit cuts. They will insist on large tax increases covering at least half the deficit. Their price for agreeing to the benefit cuts will then also include dropping the personal accounts.

Besides the problems of including major benefit cuts in the package, advancing small personal accounts that allow workers to invest only about 2 percentage points of their taxes would also minimize all of the positive features of the accounts that are giving the reform effort its political life. Little progress would be made on the fundamental goal of reducing dependency on government taxes and spending, and increasing reliance on real, personally owned, savings and capital investment.

Such a reform package would ultimately destroy the grassroots populist appeal of the reform effort. People are not going to organize at the grassroots, contact their representatives, and speak out in public forums for a reform plan of small personal accounts providing little if any net gain for them, along with major, long-term, future Social Security benefit reductions. Without powerful grassroots appeal and organization, fundamental Social Security reform can never be achieved.

Indeed, reformers need to keep in mind that the personal accounts they design must, at a minimum, be sufficiently appealing to induce workers to exercise the personal account option. Too many of the 2 percent account advocates seem to overlook this. We wouldn't want to go through all the trouble of legislating a personal account option only to find that the accounts are so limited and lacking in any real gain for workers that few, if any, actually exercise the option. Congress has legislated grand options in other areas before, such as in the Medicare system, only to find few takers once the option was in place.

A far better approach would be a progressive reform plan with no benefit cuts or tax increases, offering a 5 to 6 percentage point personal account, and more for lower-income workers. Such an account would be enough by itself to supplant Social Security retirement benefits with substantially higher benefits from the account, at just standard, long-term, market investment returns.

Such a proposal would keep the focus entirely on the personal accounts and their positive features. It would achieve all of the goals of personal account reform, and even ultimately unwind the long-term Social Security deficits by itself over the long run. Such a reform plan would generate huge, popular, grassroots fervor and political support across the spectrum. It would strongly benefit working people, young people, union workers, African-Americans, Hispanics, lower-income workers, families with children, single people, and everyone else. That is the kind of mighty, grassroots, populist, bipartisan, trans-ideological appeal that would ultimately be necessary to achieve such a major reform in our political system.

Mandatory Government Bonds in Personal Accounts

A recent analysis proposed a supposed 5 percent personal account option that would allow workers to shift only 3 percentage points of the payroll tax to the account.¹ The government would then grant these account holders government bonds equal to 2 percentage points of the payroll tax. The bonds would be non-transferable, which means the account holders could not choose to sell them and use the proceeds to buy some other investment. The worker would continue to pay 9.4 percentage points of the total 12.4 percent Social Security payroll tax, with 3 percentage points again shifted to the personal account. In retirement, the bonds would pay the worker just 2 percentage points worth of the same Social Security benefits as the worker would get without the account.

The bonds are proposed as a way of getting larger personal accounts without increasing the transition deficit resulting from the personal account option.² But personal accounts financed by such non-transferable bonds do not involve any substantive change from the current pay-as-you-go Social Security system, where the taxes paid to today's workers are almost all immediately paid out to finance the benefits of today's retirees, without any real savings and investment. In reality, the proposal still only involves a 3 percent personal account, not a 5 percent account.

The 2 percent composed of the government bonds does not to any degree substitute a private fully funded system for a public pay-as-you-go system. It just effectively runs part of the current pay-as-you-go Social Security system and the bonds used for the trust funds through the personal accounts. To the extent such bonds are used in the account, the government still just collects the taxes and pays the benefits without any real private investment occurring. The bonds do not involve real capital investment in the private sector producing market returns for the accounts. They are just a continuation of the current pay-as-you-go Social Security system under a personal account front.³

¹ Andrew G. Biggs, *Large Accounts and Small Cash Deficits: Increasing Personal Account Size Within a Fiscally Responsible Social Security Reform Framework*, SSP No. 30, Cato Institute, Washington, D.C., April 25, 2003.

² When some portion of payroll taxes are shifted to personal accounts, supplemental funds need to come from somewhere else during a transition period to continue to pay all promised Social Security benefits, because Social Security uses current tax revenues to pay current benefits, rather than saving and investing those tax funds. The needed supplemental funds are called the transition deficit.

³ As the analysis itself says, "a government bond element amounts to de facto pay-as-you-go financing." *Id.* p.13. The analysis also says, "Whether the government provides a given benefit directly through the Social Security Administration or indirectly by repaying a bond held in a personal account, the cost to the government (and thus the taxpayer) is the same." *Id.* p. 12.

After all, suppose we replaced the entire Social Security retirement system with a 10 percent account financed entirely by these government bonds that you cannot trade and that pay only what Social Security would have paid. Would we have substantively changed or privatized anything? No, we would have just given workers a Potemkin Village account where the financial and economic reality is the same as today.

The analysis proposing the government bonds states that they will be personally owned by each worker and inherited by the worker's heirs. But if you don't have the right to sell something, then you don't really own it. The "ownership" supposedly involved with the government bonds provides no new power or authority to the worker. The bonds just denote the worker's entitlement to Social Security benefits. They are not any more of an asset than the worker effectively owns under the current program.

Similarly, the "right" to inherit such a government bond, which you can't sell and which only pays a proportionate share of Social Security benefits, does not give the heir any new ownership rights or powers, or control over any real asset. It really just involves a new death benefit paid through the same pay-as-you-go Social Security system we have today, with a personal account gloss on it. The cost of this new Social Security benefit was not accounted for anywhere in the analysis proposing the bonds, so it may disappear altogether when the fact that it involves a new cost is recognized.⁴

⁴ Apart from this new Social Security death benefit, the overall proposal advanced by the analysis proposing the bonds would actually prevent the worker from achieving any significant improvement in total benefits unless the 3 percent of the payroll tax that is shifted to the personal account is invested almost entirely in stocks. That is because the analysis proposes to reduce future Social Security benefits for each dollar contributed to the account by that dollar plus an average assumed annual 3 percent real rate of return on that dollar. So to come out ahead the worker would have to earn more than a 3 percent real rate of return on the personal account investments.

But the long-term real rate of return on even corporate bonds is only about 3 percent, and the return on government bonds is less. So if the real personal account funds were invested by the worker all in bonds, the worker's future Social Security benefits would be reduced by the full amount of the benefits that could be paid by the personal account, leaving the worker overall with no more than Social Security would have paid. If the worker invested the account funds half in stocks and half in bonds, the 1.5 percentage points of the payroll tax invested in stocks would produce only a marginal gain in overall benefits. To improve future benefits significantly, the worker would have to invest almost all of the account funds in stocks.

As a result, to gain any significant benefit improvement, the worker would effectively have to forego any alternative to investing in stocks with the actual account funds. A critical element of choice for workers in the freedom to forego stocks entirely would consequently be lost, unless the worker was willing to forego instead the promise that personal accounts originally offered of better benefits for working people.

The only meaningful advantage from including the proposed government bonds in personal accounts is that all that would be necessary for a real 5 percent personal account is for the government to allow workers to sell the bonds and use the money for alternative investments. Workers could then use the proceeds from selling the government bonds for real savings and investment in their accounts. But selling these newly issued government bonds from the accounts is the same economically as the government simply issuing new bonds to the public to finance the transition. When the bonds are sold from the accounts, the government is effectively borrowing money in the capital markets to put into the accounts for the worker to invest. So why doesn't the government just sell the bonds directly to the public now to help finance the transition, and let workers shift a full 5 percentage points of the payroll tax to the account?

The analysis proposing the government bonds assumes the overall reform would include as well the proposal to switch from wage indexing to price indexing for the calculation of future Social Security benefits, which, as discussed above, would amount to a very large reduction in the future growth of Social Security benefits. It also discusses changing the calculation of the Consumer Price Index (CPI) so that Social Security COLAs would be reduced. That would also reduce the indexing of the tax brackets for the federal income tax, resulting in an income tax increase.

Such a proposal buries any possible gain from the personal accounts under a jungle of benefit cuts, tax increases and effectively meaningless government bonds. It just invites a political brawl over the benefit cuts in the plan, and counterproposals for more tax increases instead to address the Social Security deficits. In the process, any real appeal to the grassroots to get involved in fighting for reform is lost. There is little or nothing in such a proposal that can be used to appeal to grassroots African-Americans, Hispanics, union workers, or liberals more generally. To the contrary, the large, long-term Social Security benefit reductions in the proposal would just ensure their opposition. All the advantages that personal accounts were supposed to provide are minimized by the small accounts, and it is not clear that workers would even be sufficiently motivated to exercise such an account option.

The reformers supporting this approach are trying to negotiate a deal with Inside the Beltway green eyeshade accountant types. But in doing so they are giving away the true source of their strength – the grassroots appeal of personal accounts. They are also losing sight of the original goals of personal account reform. In the process, they are just setting themselves up for an ambush with Outside the Beltway grassroots Democrats and liberals. Their Inside the Beltway green eyeshade friends will be in no position to help them then.

A far wiser approach much more likely to succeed would be to maximize the grassroots appeal of the personal accounts and deal with Washington from a position of strength. That would involve, as discussed above, a progressive account allowing most workers to save and invest 5 to 6 percentage points of the payroll tax in the accounts, with more for lower-income workers. Such a proposal would deliver on the promise of personal accounts, providing workers with the full array of benefits from the reform discussed above.

Moreover, such a proposal can and should be advanced with no Social Security benefit cuts or any sort of tax increase. Any net transition deficit remaining each year after the current Social Security surpluses, revenue increases from increased investment and economic growth, resources obtained from restraining the growth of other government spending, and other such measures, can, and should, be financed by issuing federal bonds in an off-budget federal account, slated to be paid off slowly over the years. The only way personal account reform can be achieved is by taking it and the whole transition process outside the annual budget fight. Indeed, with current, near-term, projected budget deficits, no significant on budget addition to the deficit is going to be viable, even that which would result from a greatly cut down 2 percent account and broad, long-term, Social Security benefit cuts. A full-scale proposal along these lines will be published soon.

C O N C L U S I O N

President Bush should use his strong political clout now to work for a substantial, progressive, personal account in the 5 to 6 percent range on average, which will completely solve the entire scope of Social Security's problems and provide overwhelming long-term benefits to working people across the board and the nation as a whole. A 2 percent account with loads of long-term Social Security benefit cuts will not produce nearly the same benefits for workers and the nation, and offers the prospect at best of only a very costly and bloody enactment. Most likely, such an approach would fail to win passage, at enormous political cost.