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THE FERRARA SOCIAL SECURITY PLAN

by Robert Greenstein and Richard Kogan

Peter Ferrara, a conservative policy analyst and activist who is director of the International Center for Law and Economics and also functions as an adviser on Social Security to the Club for Growth and Americans for Tax Reform, has proposed a plan to divert substantial amounts of revenue from Social Security into individual accounts. The plan has drawn considerable attention. It has been promoted — and essentially endorsed — by the *Wall Street Journal* editorial page. According to Ferrara, it also has been endorsed by Jack Kemp and Empower America, Newt Gingrich, Steve Moore and the Club for Growth, Grover Norquist and Americans for Tax Reform, the American Conservative Union, and several other conservative organizations. The plan will apparently be introduced in Congress early next year.

The plan, which shifts much larger amounts from Social Security to private accounts than most previous partial privatization plans would do, is being portrayed as showing, in the words of the *Wall Street Journal* editorial page, that "large personal Social Security investment accounts can be financed without cutting benefits or raising taxes." The plan is presented by its proponents as a dramatic breakthrough that shows Social Security can be converted to private accounts on a large scale, and long-term Social Security solvency restored at the same time, while guaranteeing that all current and future beneficiaries receive total benefits at least equal to those provided under the current benefit formula, and with no increases in payroll taxes. Indeed, the plan proposes to deliver all of these things and eventually to *reduce* payroll taxes as well.

The plan is presented as having been certified as sound by the highly respected, nonpartisan Social Security actuaries. Indeed, the *Wall Street Journal* editorial page declared it to be "the conclusion of Steve Goss, the nonpartisan chief actuary of the Social Security Administration" that the plan demonstrates that large amounts of Social Security funds can be directed to private accounts — and Social Security solvency can be restored — without cutting benefits or raising taxes. Similarly, in a recent *Washington Times* op-ed, Jack Kemp announced that the actuaries "issued a favorable official analysis" of the plan, while Larry Hunter of Empower America spoke of the actuaries' "confirmation of the soundness of the Ferrara proposal."

In fact, the plan's finances rest on the assumed transfer of massive sums from the rest of the budget to Social Security, despite the fact that the budget already faces very substantial deficits as far as the eye can see. The plan shifts huge sums from the Social Security Trust Fund to private accounts and then backfills the Trust Fund with extraordinarily large general revenue transfers from the U.S. Treasury. The following data on the plan's finances come directly from the analysis of the plan that the Social Security actuaries issued and that proponents of the plan selectively cite. The actuaries reported that:

- The plan requires net general revenue transfers (with interest) totaling $68 trillion over the next 75 years, measured in 2003 dollars.

- Economists generally prefer, however, to express sums that cover long periods such as 75 years in "present value." In present value, the actuaries reported, the assumed transfers total $6.9 trillion over the next 75 years. The Social Security actuaries also have reported that the entire Social Security shortfall over the next 75 years equals $3.8 trillion in present value. In other words, the Ferrara plan relies on general revenue transfers equal to *nearly twice the entire Social Security shortfall.*

- The actuaries also reported that if these massive general revenue transfers did not materialize, the Ferrara plan would accelerate the point at which Social Security is projected to become insolvent by 28 years — from 2042 to 2014 — and would make Social Security's long-term actuarial imbalance nearly 50 percent larger than it currently is.

The claimed "seal of approval" that the actuaries are said to have placed on the plan turns out to be nothing more than a finding on the part of the actuaries that given all of the specifications Mr. Ferrara directed them to use — including the specification of extremely large general revenue transfers — the plan would restore long-term Social Security solvency. This should not be regarded as a breakthrough or a notable accomplishment. Virtually any plan that assumes general revenue transfers equal to nearly twice the Social Security shortfall should be able, on paper, to restore long-term solvency to the program. In other words, the Ferrara plan achieves its goals through an enormous "magic asterisk."

Given the sorry state of the federal budget, a truly notable accomplishment would be to develop a plan that restores long-term Social Security solvency *without* any general revenue transfers. A new book by M.I.T. economist and internationally renowned retirement expert Peter Diamond and Brookings economist Peter Orszag does that. The Diamond-Orszag plan demonstrates that it is possible to restore long-term solvency without assuming transfers from a budget already projected to be deep in deficit when the baby boomers retire, but only if one is willing to "bite the bullet" and include benefit reductions, payroll tax increases, or both.

The Ferrara plan is analyzed in more detail below.

What Mr. Ferrara Directed the Actuaries To Do

Mr. Ferrara essentially instructed the actuaries to assume away the entire Social Security deficit. He directed the actuaries to estimate the impact on Social Security of a plan that includes trillions of dollars in transfers from the rest of the budget to Social Security. The actuaries' analysis contains extensive information showing the magnitude of his general revenue transfers — and how his plan falls apart without them.

Indeed, the Office of the Chief Actuary emphasizes, on page 1 of its analysis, that "The ability of the Social Security Trust Funds to meet benefit obligations would be maintained

through transfers from the General Fund of the Treasury that would be specified in the law."[1] Without these transfers, the plan would make Social Security's deficit *larger*, not smaller. Table 1' of the actuaries' analysis examines the proposal *without* the assumed general revenue transfers. It shows that without the huge transfers, the effect of the plan would be to increase the actuarial deficit in Social Security over the next 75 years from 1.9 percent of taxable payroll to 2.8 percent of taxable payroll, an increase of almost 50 percent. The same table also shows that the Social Security Trust Funds would be exhausted in 2014, some 28 years earlier than the 2042 exhaustion date projected under current law.

The Magnitude of The Assumed General Revenue Transfers

There are several ways of expressing the size of the assumed general-revenue transfers.

- The budgetary impact of policy proposals is typically examined over the coming ten fiscal years and expressed in current (or "nominal") dollars. Table 1a from the actuaries' memo provides figures on the assumed general revenue transfers by calendar year, expressed in constant 2003 dollars. The appendix to our analysis converts these figures into current dollars, using the Consumer Price Index projections in the 2003 Social Security Trustees Report. It then converts the figures for calendar years into fiscal years, providing the figures in a form consistent with those used in Congressional budget deliberations. As the table indicates, the Ferrara plan assumes almost $1.5 trillion in general revenue transfers over the FY 2004-2013 budget window. The assumed general revenue transfers become much larger in subsequent decades.

- A second perspective comes directly from Table 1a of the actuaries' memorandum, which shows that in inflation-adjusted terms (i.e., in constant 2003 dollars) the general revenue transfer would exceed $200 billion a year by 2011, exceed $300 billion a year in 2017, surpass $400 billion a year by 2024, and reach almost $500 billion in 2030. According to the actuaries' analysis, the accumulated general revenue transfers from 2005 forward, expressed in 2003 dollars, would total $1.4 trillion by 2013, $4.1 trillion by 2020, and $68 trillion by 2078.

- For purposes of examining financial data over long periods of time, the accepted practice is to measure a long-term cost in terms of its "present value." The "present value" of the assumed general revenue transfers is the amount today that, with interest, would exactly cover the cumulative cost of the general revenue transfers for the next 75 years.[2]

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[1] Steve Goss, "Estimated Financial Effects of the 'The Progressive Personal Account Plan,'" revised December 9, 2003, page 1.
[2] The $68 trillion figure is effectively the "future value" of the transfers, which is the inflation-adjusted amount that would accumulate by 2078 from taking the general revenue transfer each year and investing the funds at an interest rate equal to the interest rate paid on Treasury bonds.

Table 1d of the actuaries' analysis presents the cost of the general revenue transfers in "present value" terms. It shows that over the next 75 years, Mr. Ferrara assumes general revenue transfers from the rest of the budget that equal $6.9 trillion in present value. This assumed general revenue transfer is nearly twice the Social Security deficit over the next 75 years, which the actuaries project to be $3.8 trillion. It should come as no surprise that the plan can eliminate the long-term deficit in Social Security: It simply assumes that the rest of the budget provides Social Security with resources almost twice the 75-year projected deficit in Social Security.

Mr. Ferrara's Assumed Financing for the Transfers

Given the magnitude of the assumed general revenue transfers, it is important to examine how they would be financed. Mr. Ferrara assumes the general revenue transfers under his plan would be financed in two ways: 1) by reducing federal spending; and 2) by assuming that corporate profits will increase substantially in the future because the plan will ignite more robust economic growth, which will generate large increases in federal tax collections that stem from the dramatic rise in corporate profits the robust growth produces. The resulting increases in federal tax receipts would help finance the general revenue transfers.

As explained below, the assumed reductions in federal spending are so large as to be implausible. Moreover, despite the magnitude of the assumed spending reductions, Mr. Ferrara does not identify *any* changes in any government programs that would be instituted to generate the rather massive spending reductions he assumes. In addition, as is also explained below, the "dynamic scoring" that Ferrara applies to corporate tax revenue is extraordinarily optimistic and is not consistent with the established practices of the Congressional Budget Office, the Joint Committee on Taxation, the Office of Management and Budget, or the Treasury Department.

Mr. Ferrara presents his reductions in government spending as though they would require only a moderate degree of restraint: a reduction in the rate of federal spending growth of one percent per year for eight years. This presentation is misleading. The cumulative effect of a reduction in growth of one percent per year over eight consecutive years amounts to an assumed *permanent* reduction in total government spending from 2013 forward that is quite substantial. Table 1d of the actuaries analysis shows that Ferrara assumes he can reduce government spending by $6.8 trillion in present value over the next 75 years.

It also should be noted that when Mr. Ferrara calculates the assumed spending reductions as a percentage of total federal spending, he includes Social Security in the federal spending base for purposes of calculating the spending reduction percentage, despite the fact that it is off limits to cuts under his plan. Social Security, Medicare, defense and homeland security, and interest payments on the debt account for the vast majority of federal spending. But Social Security is off limits under the plan, and policymakers are now busy *expanding* rather than reducing spending on Medicare, defense, and homeland security. And, of course, reductions in interest payments on the debt cannot be legislated.

It therefore is instructive to examine the size of Ferrara's assumed savings from reduced government spending relative to total non-defense discretionary spending outside of homeland security. In 2013, Mr. Ferrara's plan assumes that government spending can be reduced by $201 billion in 2003 dollars, an amount equal to 1.45 percent of GDP. Under the official CBO projections, total non-defense discretionary spending outside homeland security is expected to equal 2.9 percent of GDP that year. In other words, given the implausibility of spending reductions in Medicare, defense, homeland security, and various other entitlements such as veterans programs, the Ferrara plan essentially entails an assumption that we can eliminate close to half of non-defense discretionary spending outside homeland security. That area of the budget includes education, law enforcement, infrastructure, veterans' medical care, biomedical research, tax collecting, and national parks and other natural resources. An assumption of such severe reductions in this part of the budget is implausible.

Moreover, this implausibly large assumed reduction in government spending would have to be even larger if the individual accounts do not perform as well as current projections assume they will. Under the Ferrara plan, the federal government would guarantee that individuals would receive — from the combination of their individual accounts and traditional Social Security benefit payments — an amount at least equal to the full benefit the current Social Security benefit formula would provide. If the stock market does not perform as well as assumed, the required transfers to Social Security from the rest of the budget — and therefore the magnitude of the reductions in government spending needed to keep Social Security above water — would be even larger. Under the Ferrara plan, the budget would be significantly exposed to the risk of low stock market returns.

The Assumed Corporate Tax Revenue

The financing of Mr. Ferrara's general revenue transfers also is based on extra corporate tax revenue that he assumes will result from the creation of the individual accounts. The present value of the assumed increases in corporate income taxes also is huge — $8 trillion in present value.

Corporate income taxes would be much higher, Mr. Ferrara claims, because his reform plan would greatly boost national saving, which, in turn, would ignite investment and cause a permanent surge in corporate profits. Merely shifting payroll tax revenue from Social Security into individual accounts does not by itself boost national saving at all, however. The huge spending cuts that Ferrara envisions would increase national savings, but they are unlikely to occur. If these huge spending cuts do not materialize, the general revenue transfers consequently will be deficit financed.[3] (Under the plan, the general revenue transfers must be made regardless of whether the spending reductions materialize.) It thus is far from clear that national saving would increase at all under Ferrara's plan, let alone increase by the extremely large amounts that

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[3] National saving is the sum of public saving and private saving. When a dollar is transferred into an individual account, the direct effect is to reduce public saving by $1 and increase private saving by $1, with no net effect on national saving. (Indirect effects may cause national saving to increase or decline, but even the overall sign of the indirect effects is unclear.) The direct effect of Ferrara's assumed reduction in government spending would be to raise national saving, but as noted above, the reductions do not seem credible and may not occur at all.

Risks to Medicare

The plan also poses risks to the Medicare Hospital Insurance (HI) Trust Fund. The HI Trust Fund currently is credited with part of the income taxes paid on Social Security benefits by high-income beneficiaries. The Ferrara plan would dramatically reduce traditional Social Security benefits. Withdrawals from the individual accounts that would largely replace traditional Social Security benefits would be tax-free. The result would be to reduce revenue for the Medicare Hospital Insurance program, which already faces an insolvency problem of its own. The plan would accelerate the point at which the Medicare Hospital Insurance trust fund becomes insolvent and would increase the unfunded liability that the Medicare Hospital Insurance trust fund faces.

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he assumes. Without the increase in national saving, none of the assumed increase in corporate income taxes would occur.

Even if some increase in savings did occur, the *scale* of the assumed increases in national saving and corporate taxes that Ferrara posits also is worthy of notice. Ferrara's assumed *increase* in corporate income taxes amounts to 2.9 percent of projected GDP in 2070. By comparison, *total* corporate income tax collections averaged only 1.9 percent of GDP during the 1990s and 1.2 percent of GDP in 2003. In other words, Ferrara is assuming that corporate tax revenue will *more than double* relative to GDP as a consequence of his plan. Such an assumption is not plausible.

General Revenue Transfers Not Contingent on Offsetting Savings

Both of the financing sources for the general revenue transfers assumed in the Ferrara plan thus are unlikely to materialize in anywhere near the amounts that he assumes, if they materialize at all. The Office of the Chief Actuary of the Social Security Administration did not have to evaluate the plausibility of Ferrara's underlying assumptions in this area, however, since the general revenue transfers would be specified in law and would *not* be contingent on either government spending declining or corporate income tax revenue increasing. As the actuaries' memorandum emphasizes, "Specified transfers to the Trust Funds would, however, not be contingent on achieving these reductions in actual Federal spending." In other words, the assumed transfers to Social Security would occur regardless of whether the implausible mechanisms for financing the transfers actually worked. This underscores the recklessness of the plan.

The bottom line is that, despite his claims to have shown that Social Security solvency can be restored without any benefit reductions or payroll tax increases, all that Mr. Ferrara has shown is that he is willing to adopt implausible assumptions, and that if one assumes general-revenue transfers equal to nearly twice the entire Social Security shortfall, long-term Social Security solvency can be restored (and large private accounts created) without any benefit cuts or payroll tax increases. It bears repeating that Office of the Chief Actuary did not embrace or approve these assumptions; it merely calculated the effect on Social Security given the specifications Mr. Ferrara instructed it to use. Assuming general revenue transfers that are almost twice the entire Social Security deficit over the next 75 years does not represent a meaningful reform plan.

Appendix

General Revenue Transfers under Ferrara Plan, 2004-2013

	General revenue transfers, billions of *inflation-adjusted* dollars*	Consumer price index (2003=1.00) from 2003 Trustees Report	General revenue transfers, billions of *current* dollars	General revenue transfers, billions of current dollars, fiscal year basis**
2004	$0	1.02	$0	$0
2005	15	1.05	16	12
2006	44	1.08	48	40
2007	74	1.11	82	73
2008	106	1.15	122	112
2009	138	1.18	163	153
2010	173	1.22	211	198
2011	208	1.25	260	248
2012	244	1.29	315	301
2013	255	1.33	339	333
Total, 2004-2013	$1,257		$1,555	$1,470

* Sum of columns (1) and (2) in Table 1a of actuaries' memorandum.

** Assumes fiscal-year cost equals 75 percent of current calendar-year cost plus 25 percent of previous calendar-year cost.