The Century Foundation
41 East 70th Street, New York, NY 10021
(212) 535-4441
www.tcf.org

CENTER ON BUDGET AND POLICY PRIORITIES
820 First Street, NE, Suite 510, Washington, DC 20002
Ph: 202-408-1080 Fax: 202-408-1080
www.cbpp.org

Revised December 3, 2001

SOCIAL SECURITY REFORM:
The Questions Raised by the Plans
Endorsed by President Bush's Social Security Commission

by Henry Aaron, Alicia Munnell, and Peter Orszag[1]

In its meeting yesterday, President Bush's Social Security commission released limited descriptions of three plans that it tentatively endorsed and that would divert revenue from Social Security into individual accounts. At this point, the details of the plans remain somewhat unclear, and it is therefore impossible to produce a specific analysis of their effects. Nonetheless, the basic outlines of the plans raise three important issues that the commission should address in its final report:

- <u>Where does the money come from</u>? The commission's plans involve contributions into individual accounts that could amount to more than $1 trillion over the next 10 years and almost $3 trillion over the next 20 years. Aside from the additional payments that individuals could make (under one of the plans) on top of existing Social Security taxes, such contributions must come from one of two sources: funds diverted from the Social Security Trust Fund or funds transferred from general revenue. Given the dramatic deterioration in the budget outlook, transfers from general revenue would result in substantial deficits outside of Social Security. The commission appears unwilling to identify how such deficits would be financed. How would the $1 trillion or more be paid for?

- <u>How large are the traditional benefit reductions</u>? All three plans would reduce traditional Social Security benefits. First, they would reduce Social Security benefits by an amount that is related to the amounts that have been contributed to the individual accounts. Second, two of the plans would then use relatively obscure changes to the Social Security program to implement further reductions in traditional Social Security benefits that in some cases would amount to steep benefit reductions. In one case, for example, the change could reduce traditional benefits in 2070 by almost 50 percent relative to the benefit levels that would be provided under the current benefit formula. The other plan does little to restore long-term balance to Social Security and therefore is not truly a "reform." The commission documents provide little detail about the size of the traditional benefit reductions involved in the three plans, which is important to understanding their potential effects.

- <u>Why don't the plans restore long-term balance to Social Security</u>? Finally, *none of the three plans appear to restore long-term balance to Social Security*. The apparent failure of the commission to present even a single plan that eliminates the 75-year deficit in Social Security is disappointing.

---

[1] Henry Aaron is the Bruce and Virginia MacLaury Senior Fellow at the Brookings Institution. Alicia Munnell is the Peter F. Drucker Professor of Management Sciences at the Boston College School of Management. Peter Orszag is the Joseph A. Pechman Senior Fellow at the Brookings Institution. The views expressed here are solely those of the authors, and should not be attributed to their respective organizations in any way.

Background

The minimum standard that an individual account plan must meet includes three elements:

- It must outline a viable method of providing individual accounts.
- It must restore financial balance in the traditional Social Security program.
- It must demonstrate how each of the first two steps will be financed (especially in the context of projected budget deficits outside Social Security).

"Reforms" that do not substantially reduce the long-term deficit in Social Security do little to address the underlying problems facing the system.

Improving Social Security's long-term financial situation while diverting revenue into individual accounts requires some combination of higher payroll taxes, investing part of the Social Security trust funds in higher-yielding assets (such as stocks), transferring funds to Social Security from the rest of the budget, and reductions in Social Security benefits.[2] The commission has ruled out raising the payroll tax or having any portion of the trust fund reserves invested in equities. Consequently, the commission's only remaining choices are (1) benefit reductions within the traditional Social Security program, or (2) transferring resources to Social Security from the non-Social Security budget.[3]

Either of these two choices for restoring long-term solvency while diverting revenue from Social Security to individual accounts is problematic. If the benefit reduction approach is adopted and two percent of payroll is diverted into individual accounts, the benefit reductions that would be necessary to restore solvency within the traditional program could amount to 40 percent or more.[4] Yet if general revenue transfers are used to finance the individual account contributions, the budget deficit outside Social Security – which already appears to be substantial – would deepen.[5] In particular, primarily because the tax reductions in the tax-cut law that President Bush signed on June 7 are so large, financing contributions to individual accounts from general revenue would create substantial deficits in the non-Social Security budget.

The tax cut and the other factors contributing to the recent deterioration of the non-Social Security budget thus leave the commission with politically unpalatable choices regarding the financing

[2] Eliminating the existing long-term deficit in Social Security requires some combination of these same steps. But the diversion of revenue into individual accounts, by itself, exacerbates the long-term deficit within the traditional component of the Social Security system – and therefore requires more aggressive action to restore balance within the traditional system than is necessary in the absence of the individual accounts.

[3] Another option – raising the wage base against which Social Security taxes are paid and benefits computed – also appears to be under consideration.

[4] Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation, June 2000.

[5] For analyses of the non-Social Security budget projections, see William Gale, Peter Orszag, and Gene Sperling, "The Changing Budget Outlook: Causes and Implications," *Tax Notes*, November 19, 2001; and Richard Kogan, "Where Has All The Surplus Gone?" Center on Budget and Policy Priorities, November 14, 2001.

of the individual accounts. All of the commission's three plans appear to sidestep these difficult tradeoffs, at least to some degree. It therefore is not surprising that none of the three plans endorsed by the commission appears to restore long-term solvency to Social Security.

Issues raised by the outlines of the three plans

Issue #1: Where does the money come from?

The three plans put forward by the commission would all create individual accounts. Under each of the plans, at least $1 trillion would be contributed to individual accounts over the next ten years (if all eligible workers participated).

For example, one plan would allow workers to contribute two percent of pay into individual accounts. Assuming all workers elected to have the contributions made, the budgetary cost would amount to more than $1 trillion over the next 10 years, and almost $3 trillion over the next 20 years. How would such contributions be financed? One possibility is to finance the contributions out of general revenue. Yet over the past six months, the budget situation has deteriorated rapidly. Indeed, the Bush Administration has just acknowledged that the *unified* budget (including the Social Security surplus) may not be in balance until 2005. Longer-term projections suggest that given the large tax cut passed earlier this year, as well as the additional costs that will be necessary to fight terrorism, the budget *outside* Social Security will likely be in substantial deficit over the next 10 years, even before financing any contributions into individual accounts. So where does the $1 trillion come from? Magic asterisks are not a responsible approach to financing individual accounts.

The other alternative is to finance the contributions into individual accounts by diverting revenue from the Social Security Trust Fund. Indeed, the commission's documents suggest that some (or all) of the financing could involve such a diversion. But by itself, that would *worsen* Social Security's long-term imbalance. For example, paying for part of the contributions into individual accounts by diverting two percent of payroll from the Trust Fund, by itself, would accelerate the Trust Fund's exhaustion date from 2038 to 2024.

One of the plans tentatively endorsed by the commission would finance the contributions into individual accounts through long-term loans that would apparently not be fully repaid within the 75-year projection window used for analyzing Social Security's finances. As explained in an analysis issued in August by the Center on Budget and Policy Priorities, such a financing mechanism is an accounting gimmick that hides, but does not remove, the costs of the contributions.[6] It is a gimmick because all of the proceeds of the loan would be counted as revenue to Social Security but the portion of the loan repayments from the Social Security Trust Fund that would fall outside the 75-year window used to complete Social Security solvency would be disregarded.

Issue #2: How large are the traditional benefit reductions?

All three plans reduce traditional benefits, but the precise size of the reductions can not be analyzed without more details than the existing commission documents provide. Nonetheless, it is clear that all three plans would entail reductions in traditional Social Security benefits.

[6] Peter Orszag and Robert Greenstein, "Financing Private Accounts in the Aftermath of the Tax Bill: The Challenge Facing the Social Security Commission and the Administration," Center on Budget and Policy Priorities, August 21, 2001.

First, the three plans all involve "clawbacks" of traditional Social Security benefits. Under such a clawback, traditional Social Security benefits would be reduced by an amount that is related to the amount that was contributed to the individual accounts.

Second, two of the plans would reduce traditional benefits by much more than the clawback reductions. For example, one plan would reduce benefits (relative to the benefits that would be provided under the benefit structure under current law) by indexing initial benefit levels for future retirees to price inflation, rather than average wage growth (as is done under the current system). Since wages tend to rise faster than prices, the change would dramatically reduce benefits relative to their current-law levels. For example, under one approach to implementing this change, the benefit level for a single average earner retiring in 2060 would fall from roughly $21,500 (in 2001 dollars) to roughly $12,500 – a reduction of about $9,000.

Thus, two of the commission's three plans would reduce traditional benefits by clawing back benefits in line with the amounts contributed into the individual accounts *and* then substantially reduce benefits further. The commission does not provide sufficient information, however, to compute the size of the traditional benefit reductions.[7]

Furthermore, the one plan that does not involve reductions beyond the clawback amount is the least responsible of the three plans: It would do little, if anything, to restore long-term balance to Social Security. That concern brings us to the third issue raised by the commission's tentative proposals.

Issue #3: Why don't the plans restore long-term balance to Social Security?

It is important to realize that *none* of the three plans would apparently restore long-term balance to Social Security. Social Security is currently running surpluses. Over the next 75 years, however, the program is expected to run a deficit equal to 1.86 percent of payroll. Several commission members had earlier stated that any commission plan would eliminate that long-term deficit. The apparent failure of the commission to present even a single plan that eliminates the 75-year deficit in Social Security is remarkable.

Conclusion

The commission has put forward three alternative plans for creating individual accounts as part of Social Security. Despite the lack of detail about the plans at this point, the plans raise three troubling issues: It is unclear how they will be financed in an era of large projected budget deficits outside Social Security; they may include large reductions in traditional Social Security benefits, which are necessitated in part by diverting revenue into individual accounts; and they apparently fail to restore long-term solvency to Social Security, despite previous pledges that any commission plan would do so.

[7] Without further detail on the plans, it is also impossible to know what proportion of this benefit reduction would be replaced, on average, by income from the individual accounts. A focus on combined benefit levels, however, is inappropriate because it is unclear how the contributions into the accounts would be paid for. In other words, it is always possible to boost the retirement income from the individual accounts by expanding the size of the general revenue contributions into such accounts. The difficulty then becomes how to pay for the general revenue contributions. It is a meaningless exercise to present a plan as providing an increased level of retirement income through individual accounts without identifying how the contributions into the individual accounts would be financed.