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PREFUNDING SOCIAL SECURITY AND THE ROLE OF INDIVIDUAL ACCOUNTS

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Mr. Chairman and other members of the Committee, thank you for the invitation to address you today regarding an important facet of the Social Security reform debate – prefunding. Social Security is currently running a substantial surplus but in the coming decades the number of workers supporting each retiree will fall and the challenges facing Social Security will grow. Prefunding entails making larger initial reductions in benefits or increases in contributions in order to reduce the magnitude of the changes required in the future. At the same time, prefunding increases national savings, reducing consumption today but expanding the economy and thus consumption possibilities in the future.

An analogy can help illustrate the choices Congress faces as it crafts reforms to the Social Security system. Consider a family with a substantial mortgage on its home and a daughter who will go off to college in a decade. If the parents wants to help support their daughter's education, they have three choices:

- The parents could "prefund" their daughter's education by reducing their spending, saving more, and using the money to pay down their mortgage more quickly.

- Alternatively, the parents could use the additional savings to prefund their daughter's education by investing their new savings in an educational savings account.

- Finally, the parents could decide not to prefund their daughter's education and instead plan on reducing their future spending to pay for college when the bills come due.

All three of these are reasonable ways to finance the daughter's education. But one method is not: the family could take out a larger mortgage on their home and invest the borrowed money in an educational savings account. This would not represent prefunding. The family is no more prepared for their daughter to go to college – they have more money set aside for college but they also have

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[1] The views expressed in this testimony are mine alone.

larger mortgage payments. And the family might suffer from the dangerous delusion that they have prefunded their daughter's education. They will thus be unprepared for the combined burden of repaying the mortgage and sending their daughter to college.

In my remarks today, I will make five points that build on the simple insights about Social Security that can be gleaned from this metaphor:

- First, fully prefunding Social Security is neither warranted on policy grounds nor feasible.

- Second, partially prefunding Social Security is a sensible goal. But, if benefits for people at or near retirement are protected, prefunding can only be accomplished by raising Social Security contributions.

- Third, none of the major Social Security reform plans under discussion have any significant prefunding. All of the plans protect benefits for people at or near retirement and none contain contribution increases.

- Fourth, individual accounts – by themselves – do not do anything to prefund Social Security.

- Finally, I recommend – as a starting point – prefunding our future fiscal challenges by partially undoing some of the major fiscal errors of the last four and a half years, including the tax cuts and the prescription drug bill.

First, fully prefunding Social Security is neither warranted on policy grounds nor feasible.

Private pension plans are required to be prefunded. They must maintain sufficient assets to cover all accrued benefits – even if plan closes down and receives no future contributions. This rule was designed to ensure that companies retain the resources to pay retirees, even if they go bankrupt.

In contrast, Social Security is largely a pay-as-you-go system. The majority of benefit payments in any given year are paid for by revenues collected in that year. If payroll tax contributions ceased today, the Social Security trust fund would only be sufficient to pay benefits for the next three and a half years.

Social Security's pay-as-you-go structure originated in the 1930s. President Franklin Delano Roosevelt and the Congress that created Social Security decided that the elderly, who fought in World War I and bore the brunt the Great Depression, should immediately start receiving benefits. If Social Security had been fully advance funded, no one would have gotten full benefits until the late 1970s – after a lifetime of contributions to the system.

The policy logic that applies to a private company does not apply to Social Security. Unlike a private company, the United States will not cease to exist and the federal government can count on continued payroll tax collections into the indefinite future. With adjustments in Social Security benefits and taxes, Social Security can be made sustainably solvent.

Even if one believes that the wrong decision was made in the 1930s and wishes Social Security were fully advance funded, shifting from our current system to an advance funded system is not feasible. Doing so would require either eliminating an entire generation's benefits or doubling an entire generation's payroll taxes. Every significant Social Security reform proposal, whether with or without accounts, largely maintains Social Security's pay-as-you-go structure.

Second, partially prefunding Social Security is a sensible goal. But, if benefits for people at or near retirement are protected, prefunding can only be accomplished by raising Social Security contributions.

Partially prefunding Social Security, as part of an overall reform to restore solvency, is a good idea. America currently enjoys a more fiscally-favorable demographic structure than our country is likely to face ever again in the future. As a result, the Social Security Trustees project that the system will run a surplus through 2017 (on a cash basis) or 2027 (including interest on the trust fund). As the number of workers per retiree diminishes, Social Security will shift into deficit.

Instead of waiting for deficits to emerge, acting sooner to reduce benefits or raise contributions to Social Security would allow for smaller future adjustments. But on the other hand, future generations are likely to be richer and more able to afford adjustments. Policymakers should weigh these competing considerations. I recommend erring on the side of caution by including at least some prefunding.

Prefunding Social Security means making benefit reductions or contribution increases today that, at a more fundamental level, would raise net national savings. Raising savings should be a fundamental goal of any proposal to reform Social Security. This goal was unanimously accepted by the 1994-96 Advisory Council and endorsed by the President's Commission to Strengthen Social Security.

This goal is particularly important today because in the last three years, net national savings has averaged 1.6 percent of GDP – the lowest level in seventy years. At the same time, investment was financed by an average 4.8 percent of GDP in capital inflows from abroad – the highest level on record. Borrowing at this level is unsustainable; eventually this debt will need to be repaid. Social Security and pension reform can help increase private savings *and* reduce government dissaving (i.e., by reducing budget deficits).

Higher national savings leads to increased investment and/or reduced foreign borrowing. Either way, higher savings is the only way to increase consumption by future generations of the elderly without reducing consumption by future generations of the young.

President George W. Bush and Congressional leaders from both parties have ruled out reducing benefits for people at or near retirement. This is a sound choice because people at or near retirement have already factored their expected benefits into their financial plans and it would be too late for them to make up for reductions by saving more. But, because policymakers have ruled out reducing benefits for people at or near retirement, the only way to meaningfully prefund Social Security is to increase contributions to Social Security.

Policymakers can choose from several ways to raise contributions, including: raising Social Security tax revenues (i.e., raising the ceiling on taxable earnings, applying a smaller "legacy charge" above the ceiling, or raising payroll tax rates); raising other revenues (i.e., dedicating revenues from a reformed estate tax to Social Security); or raising the total contribution to Social Security above the current 12.4 percent FICA rate and dedicating the additional contributions to individual accounts.[2] While all of these steps would partially prefund Social Security, the choice of which provision or combination of provisions to adopt should be guided by several goals: ensuring the source of revenue is progressive, respecting Social Security's role as the core tier of retirement security, maintaining administrative efficiency, and being mindful of the interaction of prefunding with other aspects of the federal budget.

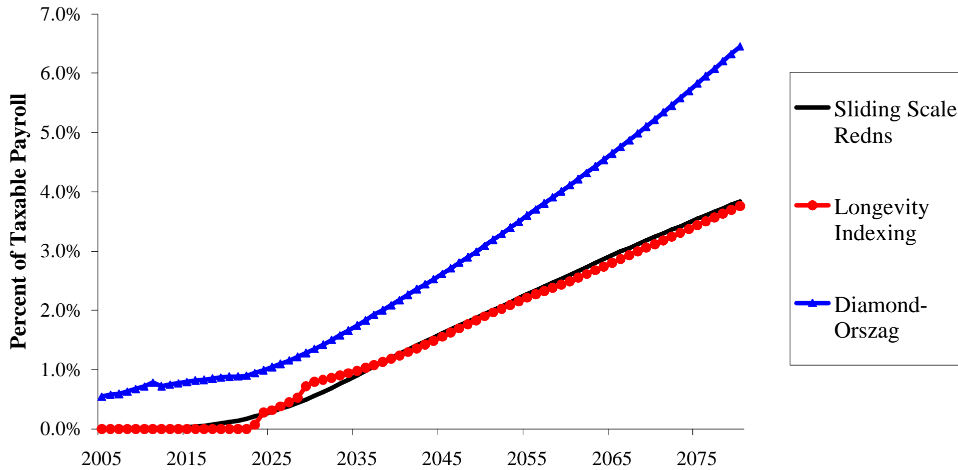
Third, none of the major Social Security reform plans under discussion have any significant prefunding. All of the plans protect benefits for people at or near retirement and do not have any contribution increases.

Few of the major Social Security proposals from recent years have any real prefunding. The proposal by economists Peter Diamond and Peter Orszag and the proposal by former Social Security Commissioner Bob Ball are the only plans scored by the Social Security actuaries that entail even modest prefunding. None of the other proposals increase the total contribution to Social Security. None of the proposals reduce Social Security benefits before about 2012 and even then the reductions in Social Security begin very gradually.

For example, consider the benefit reductions in two leading approaches: the sliding scale benefit reductions (also known as "progressive price indexing") supported by the President and benefit reductions from raising the retirement age and longevity indexing (as proposed by Senator Chuck Hagel). As shown in Figure 1, it takes more than 20 years before either plan reduces Social Security spending by 0.5 percent of payroll, a relatively modest contribution to overall solvency. In contrast, the Diamond-Orszag plan would reduce the Social Security deficit by this amount almost immediately and would continue to grow over time.

[2] Another variant of this is to establish quasi-mandatory add-on accounts by subsidizing the additional account contributions by those who choose to make the added contributions with even larger benefit reductions than would be necessary to restore solvency for those who choose not to establish accounts. This is the approach taken by Martin Feldstein and Andrew Samwick and proposed by the President's Commission Model 3. Unless the subsidies for the additional account contributions are so large that most people would participate, this approach will not result in significant prefunding.

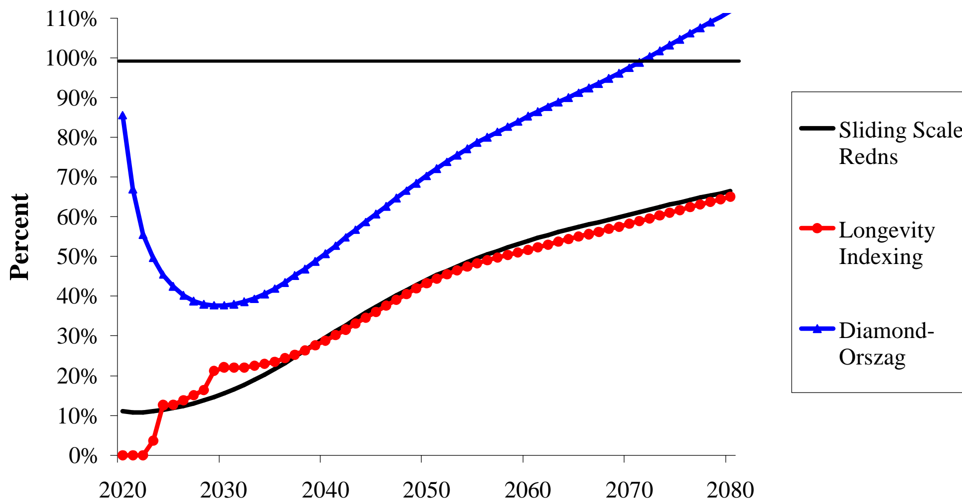
Figure 1. Reduction in Social Security Cash Flow Deficit*



* Increase in the Social Security cash flow surplus before 2017.
Note: "Sliding scale redns" indicates the President's proposal. "Longevity indexing" indicates Senator Hagel's plan to raise the retirement age to 68, index benefits for longevity, and modify the early/delayed retirement factors.

Figure 2 shows the percentage of the Social Security cash flow deficit closed by each of the three plans, excluding the individual accounts portions of the plans. Both the President's plan and the longevity indexing plan close only a small fraction of the deficit in the early years, growing to nearly 70 percent of the deficit by 2080. In contrast, the Diamond-Orszag plan closes more than 100 percent of the deficit (or modestly increases the surplus) prior to 2020 (not shown in the Figure) and thus smoothes the process of restoring sustainable solvency.

Figure 2. Percentage of Cash Flow Deficit Eliminated



* Increase in the Social Security cash flow surplus before 2017.
Note: "Sliding scale redns" indicates the President's proposal. "Longevity indexing" indicates Senator Hagel's plan to raise the retirement age to 68, index benefits for longevity, and modify the early/delayed retirement factors.

Fourth, individual accounts – by themselves – do not do anything to prefund Social Security.

Individual accounts, by themselves, do nothing to prefund Social Security. Increasing Social Security contributions – for example raising the total contribution to 15.4 percent and dedicating 3 percentage points of this to an individual account – would partially prefund Social Security. But it is not the accounts but the larger contributions that are leading to the prefunding.

No major recent individual account proposal, however, is proposing to increase total account contributions. In the last few years, every major individual accounts proposal is funded by diverting existing payroll taxes or by borrowing from the general fund. In either case, any assets in the accounts are matched by increases in the government's debt. Like the family that mortgages its house to put money in a college-savings account, this process does nothing to prefund Social Security or increase national savings.

One of the leading public finance textbooks, written by the former Chairman of President Bush's Council of Economic Advisers Harvey Rosen, explains that "privatization" by itself does not raise national savings:

> Hence, privatization can help finance future retirees' consumption only to the extent that it allows future output to increase. And the only way it can do this is by increasing saving.
>
> *However, there is no reason to believe that privatization by itself would raise national savings… At the end of the day, all that takes place is a swap of public and private securities between the Trust Fund and private markets – no new savings is created.*[3] (emphasis added)

In short, the primary effect of borrowing to finance individual accounts is no change in national savings. Furthermore, two secondary effects could be important.

First, the accounts would reduce savings if individuals treat them as net wealth and consequently decrease their savings in 401(k)s and IRAs. The completely rational actor who inhabits economics textbooks should not change his or her savings as a result of the accounts because, in the absence of additional revenue, every dollar contributed to accounts is generally matched by a dollar reduction in present value terms in future Social Security benefits.[4] The accounts do not represent net wealth but are instead are akin to a loan. Workers will still need to save as much of their own money to enjoy a dignified retirement. But, the design of individual accounts (and the way in which they are often described) could lead many people to overlook the benefit reduction associated with the account and to incorrectly assume that the accounts represent new wealth. Such people could feel less need to save in the form of 401(k)s and IRAs.[5] This would not just reduce national savings, it would also leave these people even less prepared for retirement.

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[3] Harvey S. Rosen, *Public Finance,* Seventh Edition, 2005, p. 208. Rosen goes on to explain that "sophisticated schemes" that include additional out-of-pocket contributions could increase savings. Recent carveout account proposals, including the President's proposal, do not have any of the features Rosen identified as potentially leading to higher savings.

[4] This either occurs directly as a result of the benefit offset (as proposed by President Bush) or indirectly as a result of other benefit reductions necessary to make up for the cost of subsidies for individual accounts.

[5] Douglas Elmendorf and Jeffrey Liebman provide evidence suggesting that individuals reduce savings by about 40 percent of the value of individual accounts but only increase savings by 25 percent for future reductions in Social

Second, in theory the accounts could increase savings if the higher deficits associated with them lead to lower government spending and/or higher taxes outside of Social Security. In this case, the government would not be completely financing the accounts with borrowing and national savings would increase. Note, even in this case, the same level of prefunding could be achieved without the account as long as the President and Congress have the political will to reduce the non-Social Security deficit.

But there is little reason to believe that such developments would occur. The Bush administration has not claimed that if accounts were passed it would propose additional reductions in federal programs or higher taxes to offset the increased deficit. In fact, administration officials emphasize that they do not believe there is any need for such steps because, they contend, the accounts are fiscally neutral over the infinite future. In addition, the Bush administration has not included the short-run deficit impact of the accounts in its budget submissions. It would be imprudent to base a major policy on the hope that future government spending and/or taxes would change as a result.

As a result, debt-financed accounts – including the President's proposal – are likely to reduce national savings permanently. Even with the potentially offsetting effect of phased-in benefit reductions, national savings would likely be lower and America as a whole would be poorer for several decades.

Finally, I recommend – as a starting point – prefunding our future fiscal challenges by partially undoing some of the major fiscal errors of the last four and a half years, including the tax cuts and the prescription drug bill.

Social Security is only one part, and a relatively small part, of the long-run deficit. Policymakers should focus on prefunding our overall fiscal challenges by reducing the deficit and thus increasing net national savings.

In the 1990s, policymakers put America in better fiscal shape to meet the future challenges of Social Security, Medicare, and Medicaid. In 2000, President Bill Clinton proposed devoting the entire Social Security surplus to debt reduction and devoting additional portions of the non-Social Security surplus to further debt reduction and Social Security solvency. The Social Security actuaries estimated that paying down the debt and dedicating the savings to Social Security would have extended the life of Social Security by 20 years.[6] It is important to note that these contributions constituted prefunding by increasing the unified budget surplus, reducing the debt held by the public, and raising net national savings. Prefunding does not require equity investment or individual accounts.[7]

Security benefits (like the benefit offset). As a result, they conclude that "individual accounts are likely to crowd out some other household saving." Douglas W. Elmendorf and Jeffrey B. Liebman, "Social Security Reform and National Saving in an Era of Budget Surpluses," *Brookings Papers on Economic Activity*, 2:2000.

[6] Stephen C. Goss, "Long-range OASDI Financial Effects of the President's Proposal for Strengthening Social Security – INFORMATION," June 26, 2000.

[7] In addition, the Clinton proposal included another provision to invest part of the trust fund in equities. Even using returns that are not adjusted for risk, the equity investment contributed only 6 years to solvency, much less than the genuine prefunding entailed by the additional debt reduction.

In the last five years the surplus has disappeared as a result of several rounds of large tax cuts and spending increases, and, to a lesser degree, adverse shocks. As a result, it is no longer feasible to use debt reduction to substantially prefund Social Security. Nevertheless, there is still substantial scope to close the overall fiscal gap. This is worth doing whether or not the steps are officially scored as extending the solvency of Social Security or not. Ultimately, what matters most is overall fiscal sustainability and, in this regard, the tax cuts passed from 2001 through 2004, if made permanent without causing a large increase in the Alternative Minimum Tax (AMT), would cost more than three times as much as the 75-year Social Security deficit and the prescription drug benefit will cost more than twice as much as the 75-year Social Security deficit.

As a starting point, I recommend repealing a portion of the tax cuts passed from 2001 to 2004 or, at the very least, allowing them to expire in 2010 or offsetting the cost of extending them by broadening the tax base. In addition, I recommend exploring ways to reduce the cost of the prescription drug benefit passed in 2003. This would lay a foundation for more significant deficit reduction, including policies to restore Social Security solvency.

Thank you, I look forward to the Committee's questions.