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WOULD BORROWING \$2 TRILLION FOR INDIVIDUAL ACCOUNTS ELIMINATE \$10 TRILLION IN SOCIAL SECURITY LIABILITIES?

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Administration officials have been downplaying the significance of the \$2 trillion in transition costs required by some individual accounts plans, by comparing that cost to the unfunded liability in Social Security over an infinite time horizon, which totals more than \$10 trillion. For example, White House Press Secretary Scott McClellan responded recently to a question about how the White House would pay for the \$2 trillion transition cost by arguing “It’s a savings, because the cost is \$10 trillion of doing nothing, and this will actually be a savings from that cost of doing nothing.”²

This argument is misleading. The \$10 trillion number is taken out of context; it refers to the Social Security shortfall not over 75 years, but into eternity. Social Security does face a long-term deficit, but it is relatively modest as a share of the economy; in fact, it is considerably smaller than the cost of the tax cuts passed in 2001 and 2003, if those tax cuts are made permanent. More fundamentally, borrowing \$2 trillion to fund individual accounts does nothing to reduce Social Security’s long-term deficit. Individual account plans that eliminate the long-term deficit in Social Security, such as the principal plan the President’s Social Security commission proposed, do so entirely by *reducing future Social Security benefits*, not because of borrowing.

The Misleading \$10 Trillion Figure

Most Americans hearing the \$10 trillion figure (or an \$11 trillion figure that the President cited on December 9) would not imagine that the cost of the tax cuts is larger than the Social Security shortfall. This reflects, in part, the fact that the \$10 trillion figure conveys a misleading impression of the magnitude of the Social Security shortfall. When using this figure, Administration officials have not explained that it reflects Social Security’s imbalance not over 75 years — the period normally used to evaluate Social Security’s finances — or even over centuries, but into infinity (or “over an infinite horizon,” as it is sometimes said).

Over the next 75 years, the deficit in Social Security is *0.7 percent of GDP* (or \$3.7 trillion) according to the Social Security actuaries and *0.4 percent of GDP* according to the

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² White House Press Briefing, 12/6/04. McClellan invoked the \$10 trillion figure four times during the briefing.

Social Security Shortfall Is a Fraction of the Cost of the Tax Cuts

As noted, the deficit in Social Security over the next 75 years equals 0.7 percent of GDP according to the Social Security actuaries and 0.4 percent of GDP according to CBO. By comparison, the cost over 75 years of the tax cuts enacted in 2001 and 2003, if the tax cuts are made permanent and not eroded over time by the Alternative Minimum Tax, is roughly two percent of GDP.

In other words, if the tax cuts are made permanent, their cost will be *three to five times larger* over the next 75 years than the size of the Social Security shortfall. Furthermore, just the cost of the tax cuts for the top one percent of the population — a group whose annual incomes average about \$1 million — is roughly the same size as the Social Security shortfall (0.6 percent of GDP).

Even if one uses “infinite horizon” estimates, the cost of the tax cut still exceeds the size of the Social Security shortfall. The projected cost of the tax cuts, if made permanent, is \$18 trillion under this measure, as compared to the \$10 trillion projection for the Social Security imbalance.

Congressional Budget Office. (Over an infinite horizon, the deficit is 1.2 percent of GDP, according to the Social Security actuaries.)

In December 2003, the American Academy of Actuaries, the nation’s leading professional organization of actuaries, stated that estimates of Social Security’s shortfall over an “infinite horizon” should not be used in policy discussions. The Academy warned that infinite-horizon projections “provide little if any useful information about the program’s long-term finances and indeed are likely to mislead anyone lacking technical expertise in the demographic, economic, and actuarial aspects of the program’s finances into believing that the program is in far worse financial shape than is actually indicated.”³

The Academy said that the problems with this measure are such that the \$10 trillion figure should not even be printed in the annual Trustees’ report and that including the measure in the report “is, on balance, a detriment to the Trustees’ charge to provide a meaningful and balanced presentation of the financial status of the program.”

Borrowing \$2 Trillion Would Not Eliminate the Long-term Shortfall

The impression created by the Administration’s statements — that borrowing \$2 trillion now will save \$10 trillion over time — is not correct. The basic flaw in comparing the \$2 trillion transition cost to the unfunded liability in Social Security is shown by examining the principal plan that the President’s Social Security Commission proposed, which is often referred to as “Model 2.”

The individual accounts in Model 2 would create a financing hole, which would be filled with more than \$2 trillion in transfers from the rest of the budget to Social Security. To be sure, Model 2 would eliminate the long-term deficit in Social Security, which over an infinite horizon amounts to more than \$10 trillion in present value (if that figure is used, despite the problems with using it in this manner). But the individual accounts in Model 2 *play no role* in eliminating

³ Letter from Eric J. Klieber, Chairperson, Social Insurance Committee, American Academy of Actuaries, to Trustees of the Social Security System, December 19, 2003.

this long-term deficit. The \$2 trillion cost associated with the individual account component of the plan is not the “price” of obtaining the long-term savings.

Model 2 contains three key components.⁴ The plan first restores long-term balance to Social Security and does so entirely through Social Security benefit reductions. These benefit reductions would be very large and would affect *all* beneficiaries, including disabled beneficiaries, surviving spouses and children of deceased workers, and even beneficiaries who do not elect private accounts. These benefit reductions would more than eliminate the long-term deficit in Social Security. They — and not the borrowing of \$2 trillion — are why Model 2 saves more than \$10 trillion over an infinite horizon.

Second, Model 2 would replace part of the scaled-back Social Security system that would remain (after these large benefit reductions were instituted) with a system of private accounts. Those who chose the individual accounts would have some of their payroll taxes diverted from Social Security to the accounts; in return, their Social Security benefits would be reduced further. But that would do nothing to close Social Security’s shortfall. The amount that Social Security would lose because of the diversion of the payroll tax revenues to the accounts would *exceed* the additional Social Security benefit reductions to which these beneficiaries would be subject. Moreover, this would be the case on a permanent basis, not just during a transition period.

In addition, the individual accounts would create a cash flow problem for Social Security because funds would be diverted from Social Security decades before a worker’s Social Security benefits would be reduced in return. The private accounts, by themselves, consequently would push the Social Security Trust Fund back into insolvency and would permanently worsen Social Security’s financial condition.

To avoid insolvency and restore long-term balance, the plan’s third component consists of the transfer of extremely large sums from the rest of the budget to make up for the *losses* that Social Security would bear because of the private accounts. These transfers would exceed \$2 trillion.

These transfers are not needed to address the long-term deficit in Social Security. Under Model 2 they would be necessitated by the introduction of individual accounts. As noted, those accounts would play no role in addressing the long-term imbalance and actually would make the long-term deficit larger.

Administration officials who have compared the long-term deficit under Social Security to the cost of borrowing money now to establish individual accounts thus are comparing apples and oranges. The need for the \$2 trillion in borrowing would be created by the individual accounts, and those accounts would play no role in eliminating the long-term Social Security deficit.

⁴ Peter Diamond and Peter Orszag, 2002, “Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Presented by the President’s Commission to Strengthen Social Security,” Center on Budget and Policy Priorities.