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

Perspectives on the Draft Interim Report of the President's Commission to Strengthen Social Security:

Executive Summary

by Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag

$ On July 19, President Bush's Social Security reform commission released a draft of its interim report, in preparation for its second public meeting on July 24. The commission staff earlier prepared background materials for the first commission meeting on June 11.

$ This document presents our analysis of the commission's arguments. We conclude that the commission's materials contain a number of misleading statements and factual errors that invite misinterpretation and are likely to sow confusion.

The Social Security Trust Fund and National Saving

$ The commission asserts that the Social Security Trust Fund does not hold real assets. The Social Security Trust Fund, however, currently holds more than $1 trillion in Treasury securities. These assets are backed by the full faith and credit of the U.S. Government, the benchmark of security in global financial markets.

$ Social Security's bonds are just as "real" as the Treasury bonds held by private investors. The fact that these bonds are "paper" assets does not in any way reduce their value. *All* pension funds hold paper IOUs; so would the individual accounts that the commission favors. The value of all paper assets depends on the willingness of someone to redeem them. The bonds held by the Trust Fund are, if anything, more secure than other paper assets, given the iron-clad commitment of the U.S. Government to honor its debt obligations.

$ The commission asserts that in the future, "the nation will face the same difficult choices as if there had been no Trust Fund at all." This assertion ignores the real economic contribution of the Trust Fund. The accumulation of Trust Fund reserves raises national saving, reduces the public debt and thereby reduces the annual cost of paying interest on that debt, and promotes economic growth. The commission's argument to the contrary assumes that Social Security surpluses, reflected in the Trust Fund balance, contribute *nothing* to national saving. This assumption is inconsistent with the treatment of Social Security in the national income accounts, which are the official source of data on national saving. The assertion that Social Security surpluses contribute nothing to national saving is also contradicted by historical experience, and is completely implausible today given the existence of a Congressionally established lock-box for Social Security, which ensures that Social Security surpluses are devoted to reducing public debt and raising national saving.

$ The commission argues that 2016 is the "crisis date" for Social Security, because under current projections, benefit payments in that year will exceed payroll revenue (which does not count the interest earned on the Trust Fund's assets). If the Trust Fund held no assets, 2016 would indeed be a particularly important date for Social Security. But the Social Security Trustees currently project that in 2016, the Social Security Trust Fund will contain reserves of more than $5 trillion (which is more than $3 trillion in today's dollars) and will be earning more than $300 billion a year on those assets. The commission's arguments regarding the relevance of 2016 are misguided because the Trust Fund provides resources to the Social Security system and C more fundamentally C because the accumulation of reserves within the Trust Fund has raised national saving and thereby eased the burden of financing future Social Security benefits. In addition, if 2016 were indeed a "crisis year" for Social Security, shifting two percentage points of payroll into individual accounts would *accelerate* the crisis from 2016 to 2007, nine years earlier than under current law.

$ The commission argues that increasing national saving is the only sure way to improve retirement security for current workers while also lessening the burden on future generations. We agree that national saving is a very important consideration in Social Security reform. Individual accounts financed by diverting funds from Social Security, however, would *not* raise national saving. If individuals did not change their behavior in response to the creation of such individual accounts, the transfer of funds from Social Security to individual accounts would have no effect on national saving. (Each dollar diverted from Social Security into individual accounts would reduce public saving by $1 and raise private saving by $1, with no net effect on national saving.) Once individuals' responses are taken into account, however, the net effect may well be negative: Individuals likely would reduce their other saving by a larger amount in response to a dollar deposited into an individual account in their name than they would in response to a dollar that was used to reduce public debt. As a result, the net effect of transferring funds from the Social Security Trust Fund to individual accounts may be a *reduction* in national saving.

Social Security and Progressivity

$ The commission argues that, contrary to popular perception, Social Security is not particularly progressive. Unfortunately, the commission's presentation on this important issue is biased and incomplete. It ignores recent studies showing that Social Security is becoming *more* progressive over time, it fails to compare Social Security to a likely individual account system, and it presents a misleading picture of Social Security's effects on minorities and women.

$ The benefit formula under Social Security is progressive, meaning that it provides larger benefits relative to previous earnings for lower earners than for higher earners. The Social Security system is not as progressive as its benefit formula alone would suggest, however, partly because low earners do not live as long as high earners, on average. Nonetheless, Social Security remains quite progressive: Even on a lifetime basis, it provides relatively more resources to lower earners than to higher earners. If one includes disability benefits, which accrue disproportionately to low and moderate earners, the progressive effect of Social

Security is intensified. Furthermore, and most importantly, most individual account proposals would be *regressive*.

$ The commission report attempts to portray Social Security as a particularly bad deal for African-Americans because of their shorter average life expectancies. But African-Americans and Hispanics have lower average earnings than the rest of the population and consequently benefit from Social Security's progressive benefit structure. Indeed, the study cited in the commission report as showing that African-Americans are harmed by Social Security actually finds that both African-Americans and Hispanics receive *higher* average rates of return than white Americans (primarily because of their lower earnings), a finding that the commission document fails to report.

<u>Bequests and Wealth</u>

$ The commission asserts that individual accounts would allow increased bequests to heirs and would promote wealth. The assertion that individual accounts would provide more protection for heirs than Social Security is misleading on two fronts: First, Social Security provides important benefits to heirs through survivors' benefits. In fact, $75 billion C approximately 20 percent of total Social Security benefits C were paid in 1999 to survivors of deceased workers. These benefits are superior to the benefits that would be available under some systems of individual accounts, because Social Security survivors' benefits are fully protected against inflation and private annuities are not. Second, any system that permits accumulated account balances to be transferred to heirs reduces the funds available to support retirement benefits. Individual account proponents often highlight potential payments to heirs in the abstract but then fail to include the cost of making such payments in estimating the retirement income that individual accounts would provide. They essentially count the same dollars twice.

$ The broader argument that individual accounts would increase wealth also is misleading. As a nation, the only way to increase wealth is to raise national saving. Such increased saving is the only mechanism for increasing the wealth available to the nation as a whole. As noted above, it is not clear that national saving would be any higher if Social Security revenue were diverted into individual accounts. Indeed, national saving may well be *lower*.

<u>Rate of Return</u>

$ President Bush has said that individual accounts would provide much higher rates of return than Social Security can provide. The supposed higher rates of return on individual accounts, however, are illusory.

$ The ostensibly higher rates of return under individual accounts vanish after incorporating two key adjustments. The first is an adjustment for the inevitable cost of continuing to pay benefits promised under the current system to current retirees and future retirees. The second is an adjustment to reflect the risks associated with the stock market. Indeed, if both the funds in individual accounts and the reserves held by the Social Security Trust Fund were invested in the same assets, the yield on individual accounts would be lower, not higher, than the yield on the Trust Fund. The reason is simple: Social Security would enjoy much lower administrative costs than a system of 150 million separate individual accounts.