Center on Budget and Policy Priorities

820 First Street NE, Suite 510
Washington, DC 20002

Tel: 202-408-1080
Fax: 202-408-1056

center@cbpp.org
www.cbpp.org

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REFORMING SOCIAL SECURITY SOONER RATHER THAN LATER: FACT AND FICTION

by Jason Furman

Summary

A common refrain is that it is better to act sooner rather than later on Social Security reform. President Bush, for example, argues "Putting off real reform makes fixing the system harder and more expensive."[1]

As a general principle, the common refrain is right. Acting sooner rather than later allows more of an adjustment today to benefits or taxes (or both) and thus requires smaller adjustments in the future. Making cost-saving adjustments now, when Social Security is in surplus, essentially helps to *prefund* the program for the period when deficits will emerge. In effect, the savings from the earlier reforms grow over time and enable the sacrifices made in the future to be less painful than they otherwise would have to be.

From an economic perspective, "prefunding" means reducing consumption today (either through higher taxes or lower benefits) and thereby increasing national savings, which results in more investment and a larger capital stock and thereby puts the economy in better shape to cope with future demographic challenges. Acting sooner also gives workers more time to prepare for future changes in retirement benefits.

President Bush is mistaken, however, when he argues that this logic applies to the Social Security plan he proposed last year. The President did *not* propose any meaningful prefunding. The plan he offered would not have saved any money until 2012, and would have reduced benefits by only very small amounts for a number of years after that. Eventually, the benefit reductions would have become quite large, with benefit reductions reaching 16 percent for average wage-earners who retired in 2045 and 28 percent for those retiring in 2075.[2] A plan with benefit cuts that grow to 16 percent in 2045 and 28 percent in 2075 could be enacted five or ten years from now and have virtually the same impact on solvency and the economy.

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[1] The White House, "President Discusses Strengthening Social Security In a Radio Address," March 12, 2005.

[2] Jason Furman, "How Would the President's New Social Security Proposals Affect Middle-Class Workers and Social Security Solvency?" Center on Budget and Policy Priorities, May 10, 2005.

The President's plan is somewhat like a parent who says he wants to save for a newborn child to go to college but notes, "I'll start saving for her college tuition when she's 15." If the parent waits a few years to implement the plan, he has not missed anything. He can still start saving for the child's college tuition when the child is 15. (A more sensible plan, of course, would be to start saving as soon as the child is born. Delaying that more sensible plan would carry a cost.)

Under What Circumstances Is it Better To Act Sooner than Later?

In their 2005 report, the Social Security Trustees estimated that a 1.92 percentage point increase in the payroll tax rate, starting in 2005, would keep the Social Security trust fund solvent for 75 years (i.e., through 2079).[3] If the payroll tax increase were delayed until 2010, a 2.13 percentage point increase would be required to extend solvency through 2079. The higher taxes would be needed to make up for the fact that no increase in payroll taxes had been collected from 2005 through 2009.

Similarly, cutting benefits across the board by about 13 percent starting in 2005 would be sufficient to establish 75-year solvency. Waiting another five years would require about a 14 percent benefit reduction to make up for the fact that no benefits had been from 2005 through 2009.

The plan that the President proposed last year did not contain up-front benefit reductions or tax increases to lessen the magnitude of the subsequent benefit or tax changes that will be needed. Instead, his proposal called for starting to reduce benefits for retirees who turned 65 in 2015. For the average wage earner, these benefit reductions would, as noted, grow to 16 percent people retiring in 2045 and 28 percent for those retiring in 2075. An identical plan with the same benefit reductions in the same years could be enacted in 2010. Even delaying past 2010 would not require a major change in the plan since so little of the contribution to solvency would come from the modest benefit reductions in the first decade or two.

Since the President's plan makes no up-front contributions to either solvency or national saving, there is no macroeconomic or aggregate cost to delaying its enactment. (Delay would make it slightly more difficult for people to change their savings and retirement plans in light of the benefit changes, but this would not be a major factor with a five or even ten year delay, since significant benefit reductions would not materialize under the President's plan for a few decades.)

Do Individual Accounts Constitute Prefunding?

Individual accounts, by themselves, do nothing to prefund Social Security. Increasing Social Security contributions — for example, by raising the total payroll tax contribution from 12.4 percent of wages to 15.4 percent and dedicating the increased 3 percentage points of payroll tax revenue to an individual account — could partially prefund Social Security. But it would be the increase in payroll tax contributions, not the existence of the accounts themselves, that would lead to the prefunding.

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[3] Social Security Trustees, *2005 Annual Report*. The Trustees note that larger changes would be required to maintain solvency beyond 75 years. This analysis uses the goal of 75-year solvency to make analytic points. The same points would apply if the goal were to maintain solvency through eternity.

Financing private accounts either by diverting existing payroll taxes from Social Security to the accounts or by borrowing from the general fund of the Treasury would *not* constitute prefunding. In both cases, any assets in the accounts would be matched by increases in the federal 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 to increase national savings. All of the private account proposals that have come from the Administration or Members of Congress have this feature.[4]

One of the leading public finance textbooks, written by Harvey Rosen, the former Chairman of President Bush's Council of Economic Advisers, explains that for these reasons, "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.*[5] (emphasis added)

In short, the direct effect of borrowing in order to finance individual accounts is *no change* in national savings. As a result, there is little or no economic difference between implementing these forms of accounts today or waiting for the future.

Conclusion

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 ever to face again in the future. As a result, the Social Security Trustees project that the Social Security 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. At the same time, future generations are likely to be richer and more able to afford adjustments. Policymakers should weigh these competing considerations. A balanced reform plan would likely include some prefunding.

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[4] One recent individual accounts plan developed by Jeffrey Liebman, Maya MacGuineas and Andrew Samwick would have a prefunding component because it would increase the 12.4 percent payroll tax contribution and also raise the ceiling on the amount of wages that are subject to the payroll tax. The increases in revenues would be directed to mandatory individual accounts. No member of Congress has endorsed such a plan, and the President has explicitly ruled out both additional contributions and mandatory accounts.

[5] 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.

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.

President Bush and Congressional leaders from both parties have ruled out reducing benefits for people at or near retirement. As a result, 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 small "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, assuming that the estate tax would otherwise have been repealed in whole or very large part); or raising the total contribution to Social Security above the current 12.4 percent FICA rate and dedicating the additional contributions to individual accounts. 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 overall reform 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.