



# CENTER ON BUDGET AND POLICY PRIORITIES

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## EVALUATING ALTERNATIVE SOCIAL SECURITY REFORMS

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Mr. Chairman and other members of the Committee, thank you for the invitation to address you today. America currently faces major budget deficits and perilously low national savings. These problems are expected to grow significantly over the coming decades. At the same time, Americans are struggling to plan for their retirements. Reforming Social Security and our private pension system, if done correctly, can play a meaningful role in addressing these challenges.

It is better to act sooner rather than later. But even more important than acting sooner is to obey the Hippocratic Oath: first, do no harm. If done in the wrong way, Social Security and pension reform could worsen our long-run fiscal outlook, depress national savings, and make retirement even less secure. President Bush's Social Security proposal would have all of these effects.

In my testimony I will first discuss the fundamental goals of Social Security and pension reforms. Second, I will explain why President Bush's Social Security plan fails to satisfy these goals. Third, I will evaluate the idea of replacing the President's "carveout" accounts with what proponents call "add-on accounts." I favor ways to encourage moderate income families to save more, but if add-on accounts are not focused on that goal and fully paid for by offsets, they could set back our fiscal system and Americans' retirement security. Finally, I conclude.

### I. Goals of Social Security and Pension Reform

Social Security and pension reforms should be guided by four principal goals:

1. **Restore Social Security Solvency.** If no changes are made, the Social Security Trust Fund is projected to become exhausted in 2041 and tax revenues will be sufficient to only

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<sup>1</sup> The views expressed in this testimony are mine alone. This version is revised slightly from the written testimony submitted to the House Committee on Ways and Means.

pay 74 percent of scheduled benefits in that year.<sup>2</sup> The pre-eminent goal of Social Security reform is to ensure that Social Security is sustainably solvent while using only dedicated revenue and avoiding abrupt and dramatic tax increases or benefit reductions in the future.

2. **Address America's Fiscal Challenge – Both in the Short Run and Long Run.** In fiscal year 2004, the federal government ran a unified deficit of \$412 billion, or 3.6 percent of Gross Domestic Product (GDP). Over the coming decades, the combination of phased-in tax cuts, rising health costs, and demographic changes will inexorably lead to significantly larger deficits and debt. Deficits of this magnitude reduce economic growth, increase the likelihood of an economic crisis, and will inevitably require higher taxes or lower government spending in the future. Although Social Security is not the principal source of these deficits, well-designed Social Security reform can and should play a modest role in reducing deficits both in the short run and in the long run.
3. **Strengthen Retirement Security.**<sup>3</sup> Financial planners recommend having enough income in retirement to replace about 70 percent of pre-retirement income. Social Security plays a critical role in guaranteeing a comfortable retirement for most Americans: more than two-thirds of retirees rely on Social Security for more than half of their retirement income.<sup>4</sup> But, the current Social Security system has some deficiencies, including high poverty rates for widows, high poverty rates for older beneficiaries, and the lack of an effective minimum benefit to ensure that retirees do not fall below the poverty line. To supplement Social Security, workers rely on defined contribution plans like 401(k)s and personal savings through IRAs and other vehicles. But about half of Americans work at companies that do not offer pensions and the current system provides little or no tax incentive to help moderate-income families save. Reform can strengthen retirement security by ensuring that future Social Security benefits are adequate, sustainable, and supplemented by additional savings.
4. **Increase National Savings.** Increased national savings would lead to more investment, augmenting the capital stock and thus future economic output. Or, higher national savings would reduce the need for foreign borrowing, which means that Americans would be able to consume more of our future economic output. Increasing national savings is the only way to expand the economic pie. This is the only way to ameliorate the potentially painful tradeoff between future consumption by the young and future consumption by the old. 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 and eventually this debt will

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<sup>2</sup> Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds*, (“2005 Trustees Report”). All estimates in this testimony are based on the Social Security Trustees’ assumptions.

<sup>3</sup> Strengthening disability security is also a critical priority but one that is beyond the scope of this testimony.

<sup>4</sup> Thomas Hungerford *et al.*, “Trends in the Economic Status of the Elderly, 1976-2000” *Social Security Bulletin* 64:3, January 2003.

need to be repaid. Social Security and pension reform can help increase private savings *and* reduce government dissaving (i.e., by reducing budget deficits).

Reform should advance these four goals. Any reform that impedes progress on any of these goals must be rejected. For example, it would be easy to make Social Security sustainably solvent by transferring trillions of dollars to the Trust Fund, but that would be a fiscal disaster and it would hinder efforts to increase national savings. To give another example, it would be easy to provide new tax incentives for savings. But if these tax incentives are not fully paid for and well-designed they could worsen the long-run fiscal outlook and reduce national savings.

## **II. The President's Social Security Reform Proposal**

The President has announced two parts of his Social Security plan. In his State of the Union Address on February 2, he proposed private accounts, to be paid for by reductions in traditional Social Security benefits.<sup>5</sup> In his April 28 press conference, the President proposed sliding-scale benefit reductions modeled on investment executive Robert Pozen's "progressive price indexing" plan (the White House fact sheet described this proposal as a "sliding scale benefit formula").<sup>6</sup> The White House has not provided the full details of this plan, nor has it released the traditional Social Security actuaries' memo, which provides 75-year estimates of the financial effects of the proposal and its impact on beneficiaries.<sup>7</sup> Nevertheless, the details the White House has released are sufficient to permit analysis of the proposal and its ability to meet the four principal goals of Social Security and pension reform.<sup>8</sup>

### A. The President's Proposal and Social Security Solvency

Normally the actuaries' analysis would show the impact of the President's proposal on solvency and the fiscal situation. In the absence of the traditional Social Security actuaries' analysis, I assessed the proposal using the data in the 2005 Social Security Trustees Report, as well as standard actuarial and fiscal estimates. My analysis is based on the actuaries' analysis of the Pozen proposal, the actuaries' analysis of similar private-account plans, and the actuaries' analysis of the President's private accounts through 2015.

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<sup>5</sup> White House, "Strengthening Social Security," February 2005 and Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005.

<sup>6</sup> White House, "Fact Sheet: Strengthening Social Security for Those in Need," April 28, 2005. This analysis assumes that the President's plan would have the same magnitude of benefit reductions for retirees and survivors as the Pozen plan and that his plan would add a modest minimum benefit. This assumption is consistent with the White House fact sheet's explicit claim that "this reform would solve approximately 70 percent of the funding problems facing Social Security."

<sup>7</sup> The White House has released an actuaries' memo showing the financial effects of the first 10 years of individual accounts portion of the proposal.

<sup>8</sup> All estimates are based on the assumptions of the Social Security Trustees, unless indicated otherwise. Additional details underlying this analysis are available in Jason Furman, "The Impact of President Bush's Proposal on Social Security Solvency and the Budget," Center on Budget and Policy Priorities May 10, 2005 and Jason Furman, "An Analysis of Using 'Progressive Price Indexing' To Set Social Security Benefits," Center on Budget and Policy Priorities, May 2, 2005.

### *The Impact of Sliding-Scale Benefit Reductions on Solvency*

The President has proposed sliding-scale reductions in Social Security benefits for retirees and survivors. Reductions would start in 2012 and grow over time. This proposal would postpone Social Security's cash flow deficits by only about two months – Social Security would go into cash flow deficit slightly later in 2017. Although I do not believe the date of the onset of cash flow deficits is an analytically meaningful way to measure Social Security's challenges or the impact of alternative reforms, those who do believe the 2017 date is meaningful should be concerned about the negligible impact of the President's proposal.

Any measure that does not eliminate the entire 75-year shortfall in Social Security will result in the Trust Fund becoming exhausted at some point in the next 75 years. The President's sliding-scale benefit reduction plan would push back the exhaustion of the Social Security Trust Fund by 6 years, to 2047. After that date, a roughly 15 percent across-the-board benefit cut – on top of the benefit cuts that the President has proposed – would be required to achieve solvency.

The White House states that its “reform would solve 70 percent of the funding problems facing Social Security”.<sup>9</sup> But the White House has subsequently acknowledged that this statement refers to the *deficit in the 75<sup>th</sup> year — 2079 — not to the cumulative deficit over the next 75 years.*<sup>10</sup> Unlike the President's proposal, the Pozen proposal, as Robert Pozen states, would “close the long-term deficit of Social Security by over 70%.” One-sixth of the improvements in solvency in the Pozen plan come from reductions in disability benefits. Taking into account the President's promise to shield disability benefits and the President's promise to provide a modest minimum Social Security benefit, the President's proposed benefit reductions will only close 59 percent of the 75-year deficit.<sup>11</sup>

### *The Impact of Individual Accounts on Solvency*

The President also proposes to allow workers to divert 4 percentage points of their payroll taxes (up to a maximum amount) into individual accounts. The President's proposal would require workers, in effect, to repay the “loans” these contributions represent through a reduction in their traditional defined Social Security benefit.

Diverting payroll tax revenue to private accounts would reduce the revenue available to pay Social Security benefits and thereby advance the date when the program's benefit costs exceed its non-interest income.

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<sup>9</sup> White House Fact Sheet, April 28, 2005.

<sup>10</sup> This is *not* the standard measure used to evaluate the effect of a proposal on Social Security solvency. It is, at best, a secondary measure, and one with significant weaknesses. One could design a plan that would not *start* until 2079, with no changes until that date, but that would eliminate the entire Social Security shortfall in 2079. Such a plan would fail to restore solvency over the 75-year period or to improve the fiscal outlook for the next seven and a half decades.

<sup>11</sup> Based on Peter Diamond and Peter Orszag, “Reducing Benefits and Subsidizing Individual Accounts: An Analysis of the Plans Proposed by the President's Commission to Strengthen Social Security,” June 2002. In addition, this analysis assumes the President's minimum benefit is similar to the ones proposed in Commission Models 2 and 3.

The combined effects of the President's benefit reductions and private accounts proposals would accelerate the date when Social Security's tax revenues no longer are sufficient to pay benefits to 2011.<sup>12</sup> As a consequence of the President's plan, Social Security will have to start using interest on the Trust Fund to pay benefits 6 years earlier than under current law. Under the President's benefit reductions and private accounts proposals, the Trust Fund would be exhausted in 2030 – 11 years earlier than under current law.

Moreover, the President's Social Security accounts would increase the program's projected 75-year actuarial deficit by about 0.56 percent of payroll. The Social Security actuaries estimate that the deficit will be 1.92 percent of payroll. So, taken alone, the accounts would increase the size of the 75-year shortfall by nearly one-third.

The accounts would substantially worsen Social Security's projected shortfall over the next 75 years because under the President's proposal reductions in Social Security benefits to repay the Trust Fund for the funds diverted into accounts would be made with a lag. Some of the funds diverted from Social Security to accounts over the next 75 years would not be repaid until after the end of the 75-year period.

Because the accounts would increase Social Security's shortfall over the next 75 years, the net effect of the President's proposed benefit reductions and accounts would be to close only 30 percent of Social Security's 75-year shortfall. More than two-thirds of the shortfall would remain.<sup>13</sup> To close this gap, the President's plan would require general revenue transfers amounting to \$3 trillion in present value.<sup>14</sup>

The accounts would also worsen projected solvency over the infinite horizon, but by a smaller percentage. This is because in a significant percentage of cases the benefit offset required to make the accounts actuarially neutral will not be collected. For example, if an unmarried worker dies prior to retirement his or her entire account goes to his or her estate and the benefit offset is not collected.<sup>15</sup> Or take the case of the higher-earner. In many cases, his or her entire Social Security benefit would be less than the benefit offset associated with the account. In those cases, the higher earners' entire traditional benefit would be wiped out but the Trust Fund would not collect the remainder of the benefit offset and solvency would be

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<sup>12</sup> This analysis updates the projections in the actuaries' memo for the new projections in the 2005 Trustees Report. This date was 2012, according to estimates by the Social Security actuaries based on the 2004 Trustees assumptions, see Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005. This memo estimated that the accounts would cost \$95 billion in 2011. This is larger than the \$88 billion cash surplus for 2011 projected in the 2005 Trustees Report.

<sup>13</sup> Some may try to argue that there would be a small cash-flow surplus in 2079 under the plan. This is misleading because it ignores the substantial interest payments – either by the general fund or by Social Security – associated with the accounts. The interest on the \$3 trillion in general revenue transfers that would be necessary to pay benefits through 2079 would be 4.2 percent of taxable payroll in 2079.

<sup>14</sup> According to the actuaries' memo, the Pozen plan would entail \$1.9 trillion in general revenue transfers. The transfers under the President's plan are larger both because he is proposing larger accounts (Pozen has two percent accounts) and smaller benefit reductions (Pozen's plan would reduce disability benefits and does not contain a minimum benefit).

<sup>15</sup> In the case of the Pozen plan, the benefit offset is taken directly out of the account and the account, if anything remains, is given to the estate.

worsened. This case would apply to anyone with steady earnings at or above the payroll tax cap (now \$90,000 a year) who retires after 2060. There are other such examples.<sup>16</sup>

## B. The Fiscal Impact of the President's Proposal

The President's Social Security proposal would result in a large increase in the debt held by the public, in the near-term and over the longer-term (i.e., the next 60 years).

According to the Social Security actuaries, the President's accounts would cost \$743 billion over the first seven fiscal years (from 2009 to 2015). Even this estimate is not fully reflective of the fully phased-in cost because the accounts would only be available to all workers for the last four of these seven years.<sup>17</sup>

Over longer periods, the effect on the debt would be far greater. The President's accounts would add \$1.5 trillion to the debt over the first ten years that the plan is in effect (from 2009 to 2018.) The accounts would cause the debt to increase by another \$3.8 trillion in the decade after that, for a total of \$5.3 trillion over the first twenty years.

The sliding-scale benefit reductions that the President is proposing would reduce the debt by relatively modest amounts in coming decades. Over the first twenty years, those benefit reductions would reduce the debt by \$400 billion. The combined effect of the accounts and the sliding-scale benefit reductions the White House is proposing would be to add \$4.9 trillion to the debt over the first twenty years.

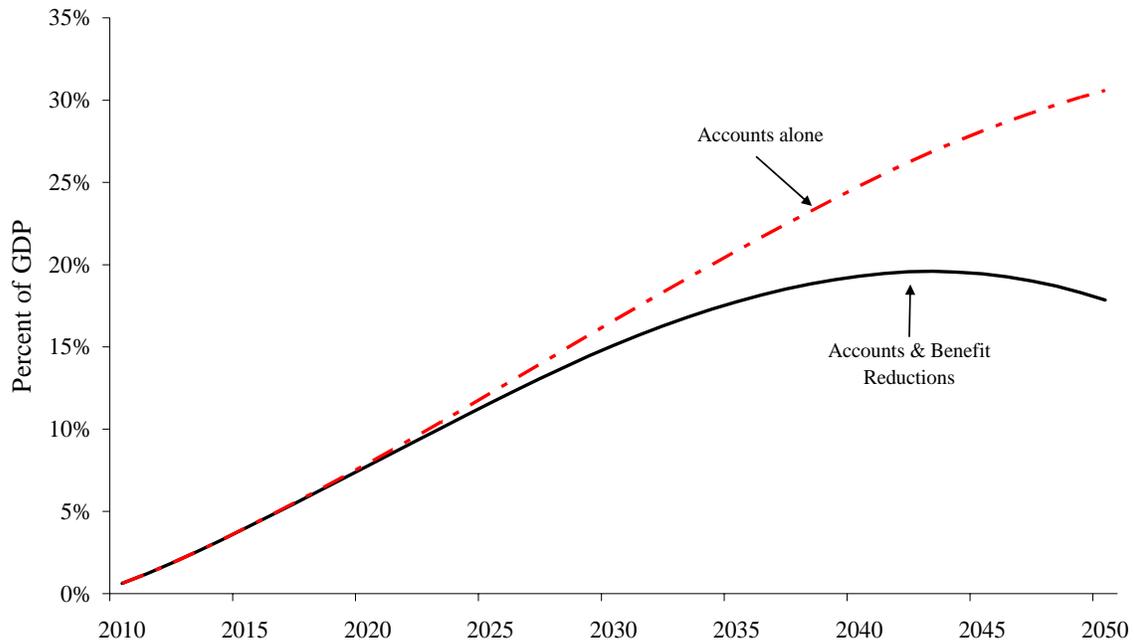
The debt would continue to rise after twenty years, both in dollar terms and as a share of GDP, as shown in Figure 1. The accounts, by themselves, would lead to *permanently* elevated debt. Although the sliding-scale benefit reductions would eventually start to bring that debt down, the debt would remain elevated through 2067. This would lead to higher interest payments on the debt, increasing the burden for future taxpayers.

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<sup>16</sup> For a further discussion of this issue, see Peter Orszag, "Social Security Reform, Testimony Before the Senate Finance Committee," April 26, 2005.

<sup>17</sup> The accounts would not be available to all workers until 2011 and they would not be phased fully in until 2041. That is the year in which the cap on the maximum amount that could be diverted to a private account each year would rise to a high enough level so that all workers could contribute a full 4 percent of their taxable earnings to the accounts.

**Figure 1. Additional Debt Held by the Public**



Source: Author's calculations.

Some have argued that the additional debt associated with the accounts would not be a source of concern for financial markets or the economy more broadly. They argue that, over an infinite horizon, this debt diminishes or disappears and that as a result even the initially high levels of debt should be considered neutral from an overall fiscal position. The accounts causing no fiscal harm is the best case scenario. No one has argued that the debt associated with the accounts has any fiscal benefits.

There is a significant probability that the debt associated with the accounts would harm the economy.<sup>18</sup> The borrowing to pay for the accounts would take the form of “explicit debt,” that is government bonds. These bonds cannot be defaulted on and must be rolled over or serviced on an annual basis. This explicit debt would replace “implicit debt” in the form of reduced future Social Security obligations. Implicit debt, however, is very different from explicit debt. It does not need to be rolled over or serviced on an annual basis. The total amount of implicit debt is based on projections and is not legally binding, unlike the tangible debt issued in the form of Treasury bonds.

Financial markets, both in the United States and abroad, are likely to be more troubled by the explicit debt than they currently are by the implicit obligations of the U.S. government. Federal Reserve Chairman Alan Greenspan testified that if financial markets did not distinguish between implicit and explicit debt, then the borrowing associated with accounts would have no impact on the market. But he went on to say, “But we don’t know that. And if we were to go

<sup>18</sup> For an extended discussion of these issues see Jason Furman, William G. Gale and Peter R. Orszag, “Should the Budget Rules Be Changed To Exclude the Cost of Individual Accounts,” *Tax Notes* January 24, 2005.

forward in a large way and we were wrong, it would be creating more difficulties than I would imagine.”<sup>19</sup>

The record is replete with nations undergoing fiscal crises because of explicit debt. No nation has undergone a fiscal crisis because of implicit debt.

Furthermore, rational financial markets would understand that the eventual repayment of the debt associated with the President’s accounts would be decades in the future and would depend on large and potentially politically unsustainable benefit reductions. To the degree that financial markets partially discounted these benefit reductions or factored in the possibility of a government bailout in the event of a major stock market crash, this added debt would have a significant impact.

In summary, the accounts portion of the President’s plan would result in *permanently* higher debt than the same plan without accounts. Even when combined with sliding-scale benefit reductions, the debt would be elevated for more than sixty years. It is important to remember that even from the vantage point of 2067, when the debt would be the same as under current law, the proposal would be judged a failure. The goal of Social Security reform is not to leave the debt the same as under current law, it is to significantly reduce the debt in order to help relieve future fiscal pressures. The debt associated with the President’s accounts proposal would have no upside benefits and substantial downside risks.

### C. The Impact of the President’s Proposal on Retirement Security

The President has not proposed any revenue increases for Social Security but instead is proposing to drain revenue from Social Security into individual accounts. Together, this necessitates very large reductions in traditional defined Social Security benefits. The President’s plan includes two sets of benefit reductions. The first benefit reduction is a sliding-scale benefit reduction that would apply to all workers making over \$20,000 per year (and, as explained below, to some beneficiaries making even less than \$20,000 per year). The second benefit reduction is the benefit offset that would apply to workers who opt for private accounts. Together, as explained below, these proposals would greatly diminish Social Security – the core tier of retirement security. The large majority of Americans would rely on investments that are subject to market risk for the large majority of their retirement income. Accounts will not necessarily make up for benefit offsets. As a result, workers would be left with substantially lower retirement income than they enjoy under the current-law formula.

#### *The First Benefit Reduction: Sliding-Scale Benefit Reductions*

The President is proposing to reduce benefits relative to the current-law benefit formula. This proposal would apply to the large majority of beneficiaries, whether or not they opt for accounts. Under the President’s proposal Social Security would replace a smaller and smaller

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<sup>19</sup> Alan Greenspan Testimony, February 16, 2005.

amount of recipients' pre-retirement income. These replacement rates are the most meaningful way to compare Social Security benefits over time.<sup>20</sup>

Social Security replacement rates would be reduced for *all* beneficiaries who make over \$20,000 annually.<sup>21</sup> In addition, as explained below, replacement rates would be reduced for some beneficiaries who make less than \$20,000 annually.

The replacement rates would be reduced more for higher-income beneficiaries. The Social Security actuaries have estimated that the average worker (someone who currently earns \$37,000) would see his or her replacement rate reduced by 16 percent in 2045 and 25 percent in 2075 (see Table 1). A so-called "high earner," someone with income 60 percent above the average (or current earnings of about \$59,000) would see his or her replacement rate reduced by 28 percent in 2045 and 42 percent in 2075. The percentage reduction in benefits would be only slightly larger for people making \$90,000 or \$9 million annually.

The percentage reductions in replacement rates for average workers under the President's proposal are larger than the reductions in any Social Security reform previously undertaken.

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<sup>20</sup> Some have proposed comparing price inflation-adjusted benefit levels over long periods of time. This, however, is an inappropriate standard in measuring a *retirement* benefit. The expectations and needs for retirement income grow with income. The amount of money that was necessary for a secure retirement in 1940 would not provide enough today. According to the Congressional Research Service, price inflation was 58.6 percent lower than wage inflation since 1940 (Congressional Research Service, "Memorandum: Estimated Effect of Price-Indexing Social Security Benefits on the Number of Americans 65 and Older in Poverty," January 28, 2005). Applying this adjustment to benefits would reduce the initial retirement benefit from \$15,000 to \$6,000. The later might be enough to meaningfully contribute to a secure retirement in 1940, but it would fall well short in 2005.

<sup>21</sup> Pozen specifies that the plan would effect people who make over \$25,000 annually in the year 2012 in 2012 non-inflation adjusted dollars. This number is adjusted to 2005.

Table 1

| <b>Social Security Benefits Under Sliding-Scale Benefit Reductions For Workers Retiring at Age 65 in Various Years</b><br>(inflation-adjusted 2005 dollars) |                            |                  |                 |                  |               |                      |
|---|----------------------------|------------------|-----------------|------------------|---------------|----------------------|
|   | <b>Current-law Formula</b> |                  | <b>Proposal</b> |                  | <b>Change</b> |                      |
|   | Benefit                    | Replacement Rate | Benefit         | Replacement Rate | Reduction     | Percentage Reduction |
| <b>Scaled Low Earner</b> (45 percent of the average wage, or \$16,470 in 2005)  |                            |                  |                 |                  |               |                      |
| 2025  | \$9,718                    | 49%              | \$9,718         | 49%              | \$0           | 0%                   |
| 2045  | 12,041                     | 49%              | 12,041          | 49%              | 0             | 0%                   |
| 2055  | 13,413                     | 49%              | 13,413          | 49%              | 0             | 0%                   |
| 2075  | 16,599                     | 49%              | 16,599          | 49%              | 0             | 0%                   |
| <b>Scaled Medium Earner</b> (average wage, or \$36,600 in 2005)   |                            |                  |                 |                  |               |                      |
| 2025  | 16,009                     | 36%              | 14,984          | 34%              | -1,025        | -6%                  |
| 2045  | 19,837                     | 36%              | 16,584          | 30%              | -3,253        | -16%                 |
| 2055  | 22,097                     | 36%              | 17,545          | 29%              | -4,552        | -21%                 |
| 2075  | 27,344                     | 36%              | 19,715          | 26%              | -7,629        | -28%                 |
| <b>Scaled High Earner</b> (160 percent of the average wage, or \$58,560 in 2005)  |                            |                  |                 |                  |               |                      |
| 2025  | 21,228                     | 30%              | 19,190          | 27%              | -2,038        | -10%                 |
| 2045  | 26,302                     | 30%              | 19,858          | 23%              | -6,444        | -25%                 |
| 2055  | 29,296                     | 30%              | 20,214          | 21%              | -9,082        | -31%                 |
| 2075  | 36,254                     | 30%              | 21,100          | 18%              | -15,154       | -42%                 |
| <b>Steady Maximum Earner</b> (taxable maximum, or \$90,000 in 2005)   |                            |                  |                 |                  |               |                      |
| 2025  | 25,929                     | 24%              | 22,999          | 21%              | -2,930        | -11%                 |
| 2045  | 32,153                     | 24%              | 22,829          | 17%              | -9,324        | -29%                 |
| 2055  | 35,751                     | 24%              | 22,666          | 15%              | -13,085       | -37%                 |
| 2075  | 44,236                     | 24%              | 22,428          | 12%              | -21,808       | -49%                 |

Source: Author's calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005 and Social Security Trustees, *2004 Annual Report*. Note that all percentage reductions in benefits are taken directly from the actuaries' memo.

The President's Social Security proposals have been widely reported as protecting benefits for the bottom 30 percent of the population, people earning less than \$20,000 today. But a document that the White House gave reporters in a press briefing on May 4 contains charts which show that the bottom 20 percent of beneficiaries *lose* benefits, on average, under its plan.<sup>22</sup> While the President's plan does protect low-income retirees who earn benefits based on their own work histories, it does not necessarily protect people who earn so-called "auxiliary" benefits based on another person's work history. For example, widows, surviving children and ex-

<sup>22</sup> White House, "Interpreting the Benefit Estimates for the Pozen Provision," May 2005. For further analysis of this White House document, see Jason Furman, "White House Distortions Mask Social Security Benefit Reductions," May 6, 2005.

spouses all get benefits based on another worker's earnings. If that worker makes over \$20,000 annually (i.e., is in the top 70 percent), the widows, surviving children or ex-spouses would all get benefit cuts – even if the beneficiaries themselves have a much lower income, as they well may in the aftermath of a deceased worker's death or a divorce.

The White House analysis shows that average Social Security benefits for the bottom quintile of beneficiaries (aged 62 to 76 in 2050), would be \$866 a month under the current benefit structure, but only \$822 a month under the President's plan. This represents an average benefit reduction of \$528 a year for beneficiaries in the bottom quintile. In fact, the White House numbers are likely to understate the benefit reductions for these groups for reasons described in more detail elsewhere.<sup>23</sup>

### *The Second Benefit Reduction: The Benefit Offset for Private Accounts*

In addition to the first benefit reduction, workers who opt for the President's proposed private accounts would be subject to a second reduction in their traditional defined Social Security benefit.

Under the President's proposal, workers could contribute up to 4 percent of taxable wages to private accounts. These contributions would be capped at \$1,000 in 2009, with the cap increasing thereafter by \$100 per year, plus wage inflation. By 2041, all workers would be able to contribute a full 4 percent of taxable payroll to their accounts. Workers who elect private accounts would have their traditional Social Security benefit reduced by their contributions to the accounts, plus an interest charge set at 3 percent above the inflation rate.

The combination of the sliding-scale benefit reductions and the benefit offset associated with private accounts would radically transform retirement, leaving the average worker with a fraction of the traditional Social Security benefit he or she is entitled to today. Consider an average worker retiring in 2055, the first worker who would be eligible to participate fully in the President's proposed accounts. The sliding-scale benefit reduction would reduce this worker's scheduled benefit by 21 percent. The benefit offset would reduce the scheduled traditional Social Security benefit by 45 percent. Together, these two benefit reductions would reduce the traditional defined benefit by 66 percent. This worker would have a guaranteed benefit of only \$7,500 annually, or a replacement rate of about 12 percent of pre-retirement income. The majority of the workers' retirement income would come from the individual account, pensions, and other savings – all of which is subject to market risk.

These double reductions in benefits grow dramatically for higher income workers and workers retiring later, as Table 2 shows. For example, a worker making the equivalent of \$59,000 in today's wage-adjusted dollars and retiring in 2075 would see a 97 percent reduction in his or her traditional defined Social Security benefit. Virtually all of this workers retirement income would come from the individual account and other savings.

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<sup>23</sup> Jason Furman, "New White House Document Shows Many Low-Income Beneficiaries Would Face Social Security Benefit Cuts Under the President's Plan," Center on Budget and Policy Priorities, May 10, 2005.

Table 2

| <b>Annual Social Security Defined Benefits (Excludes Account Value)</b><br>(inflation-adjusted 2005 dollars) |                                |   |  |                                      |                              |
|--|--------------------------------|---|--|--------------------------------------|------------------------------|
|  | <b>Current-law<br/>Formula</b> | <b>Sliding-<br/>Scale<br/>Benefit<br/>Reduction</b> | <b>Benefit<br/>Offsets for<br/>4%<br/>Accounts</b> | <b>Total<br/>Defined<br/>Benefit</b> | <b>Percentage<br/>Change</b> |
| <b><u>Workers Retiring in 2055 At Age 65</u></b>   |                                |   |  |                                      |                              |
| Low earner   | \$13,413                       | -\$0  | -\$4,507   | \$8,906                              | -34%                         |
| Medium earner  | 22,097                         | -4,522  | -10,062  | 7,513                                | -66%                         |
| High earner  | 29,296                         | -9,082  | -16,464  | 3,750                                | -87%                         |
| Maximum earner   | 35,751                         | -13,085   | -19,949  | 2,717                                | -92%                         |
| <b><u>Workers Retiring in 2075 At Age 65</u></b>   |                                |   |  |                                      |                              |
| Low earner   | 16,599                         | -0  | -5,577   | 11,022                               | -34%                         |
| Medium earner  | 27,344                         | -7,629  | -12,414  | 7,301                                | -73%                         |
| High earner  | 36,254                         | -15,154   | -19,867  | 1,233                                | -97%                         |
| Maximum earner   | 44,236                         | -21,808   | -32,557  | 0                                    | -100%                        |

Source: Author's calculations based on Social Security Administration, Office of the Chief Actuary, "Estimated Financial Effects of a Comprehensive Social Security Reform Proposal Including Progressive Price Indexing -- INFORMATION," February 10, 2005 and "Preliminary Estimated Financial Effects of a Proposal to Phase In Personal Accounts -- INFORMATION," February 3, 2005. Note that the 4 percent accounts are assumed to have a maximum contribution of \$1,000 in 2009, growing by \$100 per year plus wage inflation, along the lines proposed by the President.

When Medicare premiums are deducted from Social Security benefits, the results are even more dramatic. Subtracting these premiums would leave little or no traditional Social Security benefit for anyone retiring after 2055 with an income that is above the equivalent of about \$35,000 today. These workers would have to rely entirely on their private accounts for all of their other needs.

The combination of sliding-scale benefit reductions and carveout accounts raise very serious concerns about the unraveling of Social Security. The benefit offset for the accounts is designed in such a manner that it would lead participants to devalue their traditional Social Security benefits (and all the associated disability insurance, life insurance, and other advantages) and overvalue their private accounts. Many Americans would appear to get little or nothing from their traditional Social Security contributions, while lower-income families would still get relatively more substantial benefits. This could lead to significant political pressure to shift more of Social Security into private accounts and reduce defined benefits for lower-income workers.

#### *Would Higher Returns on Accounts Make Up for These Benefit Reductions?*

Would the accounts the President is proposing help make up for these benefit reductions? The way the accounts are structured, a participant would need to get a rate of return (after subtracting administrative costs) that is more than 3 percent above the inflation rate to make up

for the second benefit reduction, the benefit offset. A rate of return well above 3 percent would generally be needed to make up for both sets benefit reductions.

In effect, the President's accounts are structured like a margin loan. If you do not get a high enough return to make up for the margin interest, you lose money on the account. If you come out ahead of the margin interest rate, your net retirement benefit only goes up by the degree to which your return exceeds 3 percent above inflation, not by the entire value of the account. In the words of former Securities and Exchange Commission Chairman Arthur Levitt Jr.:

Every dollar you take out of traditional Social Security and put into a PSA must be paid back out of your Social Security benefit – plus interest. If this sounds a lot like margin investing, it should not be a surprise since the PSA plan is modeled on that concept: A worker investing in a PSA would hope – like a margin investor – that assets accrued were greater than debts (money lent plus interest). If not, he would end up with a smaller Social Security benefit than if he stayed in the traditional system. To come out ahead, then, an investor would have to earn a rate of return that exceeds the interest of the loan, plus expenses.<sup>24</sup>

The President has proposed to set up “lifecycle” accounts as the default option for investors. These accounts would switch portfolio allocations towards bonds as a worker nears retirement. The goal is to capture potentially higher stock market returns while reducing the risks associated with stock market investment. Noted financial economist Robert Shiller, author of *Irrational Exuberance*, however, showed that “lifecycle” accounts do not provide a free lunch and are still subject to considerable risks.

Shiller conducted a simulation using historic returns from 1871 to 2004 to answer the question of whether or not workers would come out ahead of the 3 percent hurdle required to make up for the second benefit reduction.<sup>25</sup> Using actual historical returns, Shiller found that workers opting for a “lifecycle account” modeled on the President's proposal would end up losing money 32 percent of the time. That is, 32 percent of the time workers would not even make enough to overcome the benefit offset. They would be worse off as a result of opting for the accounts.

Shiller found a median rate of return with the lifecycle accounts of 3.4 percent above inflation. That is above the 3 percent hurdle required to break even on the private accounts but well below the 4.6 to 4.9 percent rate of return assumed by the Social Security actuaries. In most cases, this would not be enough to make up for the sliding scale benefit reduction.

Shiller, however, believes that these historical returns are likely to overstate the returns to accounts because future stock market returns are not likely to be as high as past returns. As a result, he conducted the simulation using what he considers more “realistic” returns that are more reflective of future stock market performance. Shiller finds that workers would lose money on the accounts 71 percent of the time. The median rate of return would be 2.6 percent above

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<sup>24</sup> Arthur Levitt Jr., “Reform is Good, PSAs Are Not So Good,” *Wall Street Journal*, April 26, 2005.

<sup>25</sup> Robert Shiller, “The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation,” March 2005.

inflation. Professor Shiller concludes that the accounts are a bad deal. This is also the conclusion reached by Goldman Sachs Chief Economist Bill Dudley who concluded that the accounts are “not an attractive proposition.”<sup>26</sup>

Even the more realistic returns assumed for the second part of Shiller’s study are *higher* than the returns projected by a wide range of financial economists surveyed by the *Wall Street Journal* in February.<sup>27</sup> In addition, a recent paper by economists Dean Baker, Brad DeLong, and Paul Krugman demonstrates that if economic growth slows as much as the Social Security Trustees project, stock returns are likely to be lower than in the past.<sup>28</sup>

Moreover, even these lower rates of return do not take into account the additional risks associated with equity investment. Virtually all economists agree that any assessment of the likely outcome of this margin loan should take into account the additional risks associated with investing in equities. As Gary Becker, a Nobel Laureate in economics and supporter of individual accounts explains: “There are no freebies from such investments since the higher return on stocks is related to their greater risk and other trade-offs between stocks and different assets.”<sup>29</sup>

The Congressional Budget Office (CBO) uses what is known as “risk adjustment” in estimating the featured returns on private accounts established under Social Security plans. This means that CBO adjusts stock returns to reflect the higher risk that stock investments carry. Under CBO’s analyses, private accounts “are expected to earn an annual return of 3.0 percent [above inflation],” after adjustment for risk.<sup>30</sup> Risk adjustment makes the balances in private accounts (which are subject to market risk) comparable to the value of the guaranteed Social Security benefit (which is not subject to market risk).<sup>31</sup> Without adjusting for risk, comparing the certain balance in a traditional benefit to the uncertain balance in a private account is misleading.<sup>32</sup>

Both CBO and the Office of Management and Budget use this risk-adjustment methodology when estimating the returns that the Railroad Retirement Fund will earn on its stock investments for the purposes of official government accounting.

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<sup>26</sup> William Dudley, “Social Security Reform: Are Personal Savings Accounts Attractive?” *Goldman Sachs US Daily Comment*, February 23, 2005.

<sup>27</sup> Mark Whitehouse, “Social Security Reform Plan Leans on Bullish Market,” *Wall Street Journal*, February 28, 2005.

<sup>28</sup> Dean Baker, Brad DeLong and Paul Krugman, “Asset Returns and Economic Growth,” March 2005.

<sup>29</sup> Gary Becker, “A Political Case for Social Security Reform,” *Wall Street Journal*, February 15, 2005.

<sup>30</sup> Congressional Budget Office, “Long-term Analysis of Plan 2 of the President’s Commission to Strengthen Social Security,” July 21, 2004. CBO assumes a risk-adjusted rate of return on investment of 3.3 percent, which is CBO’s projected return on Treasury bonds, minus 0.3 percent for administrative and management fees.

<sup>31</sup> Some have argued that the benefit under the traditional system is subject to political risk. But these same political risks also apply to total benefits under the system with accounts. The remaining traditional benefit could be reduced further, a tax could be applied to individual account accumulations or withdrawals, or the government could modify the interest rate used to calculate benefit offsets. There is no sense in which this political risk disproportionately applies to the current system and thus it does not effect the comparison of the level of benefits under the two plans.

<sup>32</sup> Office of Management and Budget, *Analytical Perspectives, Fiscal Year 2006 Budget*, February 2005, p. 421.

From the perspective of risk adjustment, workers would not come out ahead if they opt for private accounts.<sup>33</sup> Private accounts simply introduce substantial additional risk into the core tier of retirement security without doing anything to lessen the sliding-scale benefit reductions the President is proposing.

Table 3 summarizes the scenarios described in this section for an average earner retiring in 2075 under the President’s proposal. This worker is subject to a \$7,629 sliding-scale benefit reduction and a \$12,414 benefit offset. The table shows the account annuities the worker would get under alternative investment return scenarios.

In the risk-adjusted case, the featured case in CBO analysis, the account exactly makes up for the benefit offset – leaving the worker subject to the full sliding-scale benefit reduction. Using what Shiller describes as “realistic” returns on a lifecycle account, the account would only get a 2.6 percent return and thus fall short of even making up for the benefit offset leaving the worker even further behind. Actual historical returns with a lifecycle account or the returns forecast by leading economists surveyed by the *Wall Street Journal* are both 3.4 percent – enough to make up for the benefit offset but not nearly enough to make up for the sliding-scale benefit reduction.

Table 3

| <b>Effect of Alternative Account Returns on Total Benefit</b><br>(inflation-adjusted 2005 dollars) |  |                           |                                     |                   |
|--|--|---------------------------|-------------------------------------|-------------------|
|  | <b>Sliding<br/>Scale<br/>Benefit<br/>Reduction</b> | <b>Benefit<br/>Offset</b> | <b>Annual<br/>Account<br/>Value</b> | <b>Net Change</b> |
| Low Return Case (2.0%)   | -\$7,629   | -\$12,414                 | 10,316                              | -9,727            |
| Realistic Lifecycle Return (2.6%)  | -7,629   | -12,414                   | 11,774                              | -8,269            |
| <b>Risk-adjusted Returns (3.0%)</b>  | <b>-7,629</b>                                      | <b>-12,414</b>            | <b>12,414</b>                       | <b>-7,629</b>     |
| Historical Lifecycle Return (3.4%)   | -7,629   | -12,414                   | 14,125                              | -5,918            |
| <i>Wall Street Journal</i> Survey (3.4%)   | -7,629   | -12,414                   | 14,125                              | -5,918            |
| High Return Case (4.6%)  | -7,629   | -12,414                   | 18,779                              | -1,264            |

Notes: Lifecycle returns are the annual internal rates of return on lifecycle accounts estimated by Shiller. For the “historical” sample the average stock return is 6.8 percent annually and the average bond return is 2.7 percent annually. The *Wall Street Journal* returns uses the median returns from the *Wall Street Journal* survey on February 28, 2005, assuming the same portfolio proposed by the President’s Commission to Strengthen Social Security.

<sup>33</sup> This is true to the degree that Treasury yields are 3 to 3.3 percent, as projected by the Social Security Trustees and CBO respectively. Workers, however, would be slightly better off from opting into the accounts because of the leakage: there is a chance they would not have to repay their full offset due to pre-retirement death, a high income, or other factors. All of these benefits, however, would be reflected in the reduction in solvency and thus would require correspondingly larger reductions in the traditional benefit. These would not be *net* benefits, just reallocations of existing benefits.

#### D. The Impact of the President's Proposal on National Savings

Raising net national savings should be a fundamental goal of any proposal to reform Social Security and pensions. This goal was unanimously accepted by the 1994-96 Advisory Council and endorsed by the President's Commission to Strengthen Social Security. Higher national savings leads to increased investment and/or reduced foreign borrowing. Either way, higher savings is the only way to increase consumption by the elderly without reducing consumption by the young.

The President's accounts proposal (by itself and not counting the benefit reductions), does nothing to raise national savings and could even result in lower national savings.<sup>34</sup> The President's plan would put money into accounts (representing saving) while contemporaneously financing these contributions with higher federal borrowing (representing dissaving). The net effect would be no increase in savings.

One of the leading public finance textbooks, written by the current Chairman of the 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. The government by itself has to finance its deficit one way or another. In order to induce private investors to accept government bonds that would have been bought by the Trust Fund, their yield has to go up (increasing the debt burden on taxpayers), or the yield on stocks must fall, or both. 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.*<sup>35</sup> (emphasis added)

The primary effect of the President's accounts proposal is no change in national savings. As a result, the proposal fails to meet one of the principal goals for Social Security reform – increasing national savings. Further, two secondary effects could be important.

First, the accounts would reduce savings if individuals treat them as net wealth and consequently decrease their 401(k)s and IRAs savings. The completely rational actor that inhabits economics textbooks should not change his or her savings as a result of the accounts: every dollar contributed to the account is matched by a dollar reduction in present value terms in

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<sup>34</sup> The benefit reductions in the President's plan could lead to modest increases in national savings over time, although they would do relatively little to pre-fund Social Security by substantially increasing up-front savings. This subsection is concerned with the question of whether the accounts in the President's proposal would further or set-back the effort to increase national savings.

<sup>35</sup> 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. The President's carveout accounts do not have any of the features Rosen identified as leading to higher savings.

future Social Security benefits. As a result, the accounts do not represent net wealth but are instead a loan. Workers will still need to save as much of their own money to enjoy a dignified retirement. But, the design of the President's accounts (and the way in which they are often described) could lead many people to ignore the benefit offset 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.<sup>36</sup> This would not just reduce national savings, it would also leave these people *even less* prepared for retirement.

Second, in theory the accounts could increase savings if the higher deficits associated with accounts lead to lower government spending and/or higher taxes. In this case, the government would not be completely financing the accounts with borrowing and national savings would increase. This theory depends on the behavior of the current government and future governments. 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, the President's accounts proposal, by itself, is likely to reduce national savings permanently. Even with the potentially offsetting effect of the sliding-scale benefit reductions, national savings would likely be lower and America as a whole would be poorer for several decades.

### **III. Alternative Approaches to Encouraging Savings**

To encourage savings some have proposed "add-on" accounts for Social Security, additional savings incentives, and other pension reforms. Advocates argue that these approaches could sweeten a Social Security reform package that contains strong medicine such as the benefit reductions that the President proposed. But, if the sweetener is funded through deficit spending or does nothing to help make retirement more secure for most families, it could instead become a poison pill. Furthermore, if add-ons are poorly designed, they could reward the existing saving by those who need it least, while doing little to encourage future saving by the families who need help most. There are, however, promising approaches that could encourage savings and be enacted with or without Social Security reform.

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<sup>36</sup> 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 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.

## A. The Fiscal Impact of Add-On Accounts

In evaluating add-on accounts, the first and most important question is: do they increase the deficit and the debt? If the answer is yes, then the add-on accounts would be a step backwards.

Any voluntary add-on accounts for Social Security would likely be ineffective and counterproductive. Only 5 percent of Americans are currently contributing the maximum to their IRAs and 401(k)s.<sup>37</sup> There is no reason that a worker would make additional contributions to an add-on account when they already have other tax-advantaged ways to save. The only way to encourage add-on contributions would be to provide new tax incentives for contributions to the Social Security accounts. But if the new tax incentives are not fully offset by other changes, they would worsen the long-run fiscal situation and thereby undermine the main goal of Social Security reform.

One example is Congressman Clay Shaw's proposal. He proposes to allow individuals to contribute 4 percent of payroll, up to a maximum of \$1,000, into "Social Security Guarantee Accounts." Instead of deducting this amount from payroll taxes and the Social Security Trust Fund (as the President proposes), the Shaw plan would instead fund these contributions with general revenue. The distinction between this approach to funding accounts and the President's carveout proposal is purely a matter of accounting; there is no economically meaningful difference.<sup>38</sup> Both plans would fully fund individual accounts with contemporaneous borrowing. In fact, if anything the Shaw approach could be more problematic because it is less transparent about recording the costs of the new accounts.

Another type of add-on account would graft proposals like Retirement Savings Accounts (RSAs) onto Social Security. For example, some Social Security reform plans have included a provision to allow workers at any income level to make up to \$5,000 per year in additional contributions to their private accounts. Contributions get preferential tax treatment – neither interest earned on them nor withdrawals made in retirement would be taxed. (This tax treatment is the same as that is accorded to Roth IRAs.)

These new tax savings would have little cost in the traditional 5- or 10-year budget window because most of the tax benefits are deferred.<sup>39</sup> The long-run cost, however, is substantial. A preliminary estimate is that creating a new \$5,000 tax-free account would cost about 0.28 percent of payroll over 75 years or about \$600 billion in net present value, over 75 years.<sup>40</sup> This would worsen the long-run fiscal outlook.

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<sup>37</sup> Craig Copeland, "IRA Assets and Characteristics of IRA Owners," *EBRI Notes*, December 2002

<sup>38</sup> The President's plan and the Shaw plan have different mechanisms for repaying the account. This difference, however, is not inherent to whether or not the plan is structured as an add-on or a carveout.

<sup>39</sup> In fact, if the proposal allows workers to convert deductible IRAs to Roth-style savings accounts it can even appear to raise money in the first few years by, in effect, borrowing from the future at unfavorable rates.

<sup>40</sup> This is based on an extrapolation of a preliminary 10-year estimate by the Urban Institute-Brookings Tax Policy Center.

Even otherwise desirable new tax incentives for savings – like extending and improving the saver’s credit – could be counterproductive if they promoted retirement savings while increasing the long-term budget deficit.

## B. Reforms to Promote Retirement Security

Roughly half of households do not have an employer-sponsored pension. The typical household approaching retirement has a defined contribution account balance of \$10,000.<sup>41</sup> The assets and participation rates for moderate- and middle-income households are even lower.

The economic evidence shows that savings incentives can be most effective at creating *new* savings when they target moderate-income families who are not saving much currently.<sup>42</sup> In contrast, higher-income families are generally saving a substantial amount already. Expanding savings incentives for these families is likely to lead them to shift their existing saving into tax preferred vehicles. As a result, no new savings is created.

The current tax system is “upside down” – it gives the largest incentives to families that need them the least and are the least likely to save more as a result.<sup>43</sup> Tax preferences for retirement savings, like deductions or exclusions, benefit families based on their marginal rates. If a family is paying no income taxes at all, then it does not benefit at all from tax incentives for savings. But these are precisely the families who need the most help saving and there is the most potential to genuinely increase savings among these moderate-income families. Yet, families in higher tax brackets benefit more from the tax preferences for saving. In total, the Federal government incurred \$184 billion in costs on tax expenditures for savings in 2003 (in present value terms). Of this only 3 percent goes to the bottom 40 percent of Americans while 49 percent goes to the top 10 percent of Americans.<sup>44</sup>

Carveout accounts would not change the current system at all and would not encourage new saving; they simply represent, in effect, a loan that must be repaid out of defined Social Security benefits.

Add-on proposals modeled on RSAs would make the current system even worse by giving more than 90 percent of the benefit of the tax expenditures to the top 10 percent of Americans. Expanding the maximum annual contribution to IRAs would do nothing for the 95 percent of Americans who currently contribute less than the limit to their existing IRAs. Eliminating the income limit on Roth IRAs (currently set at \$160,000 for married couples) would only provide benefits to high-income Americans.

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<sup>41</sup> Peter Orszag, “Progressivity and Saving: Fixing the Nation’s Upside-down Incentives for Savings,” Testimony Before the House Committee on Education and the Workforce, February 25, 2004.

<sup>42</sup> Eric Engen and William Gale, “The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups,” NBER Working Paper, 2000.

<sup>43</sup> For further discussion see Gene Sperling, “A Progressive Framework for Social Security Reform,” January 10, 2005.

<sup>44</sup> Leonard Burman, William Gale, Matthew Hall, and Peter Orszag, “Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts,” Tax Policy Center Discussion Paper No. 16, August 2004.

Expanded RSA-style tax incentives could provide a windfall for high-income families that more than makes up for the reduction in their Social Security benefits. At the same time, raising income and contribution limits would not do anything to offset the reductions in benefits for the vast majority of middle-class families. To illustrate this point, consider the two hypothetical families. Both are subject to the President's sliding-scale benefit reductions and both have the option to contribute up to \$5,000 annually to an account that accumulates tax free and can be withdrawn at retirement tax free:

- The Smiths make \$400,000 annually and retire in 2055. Under the sliding-scale benefit reduction, their annual Social Security benefit is reduced by \$13,085. At the same time, the Smiths put \$5,000 annually into the new tax-free savings account (previously they had saved this money in a taxable account). By the time they retire, the tax benefits associated with this account save them \$250,000 in inflation-adjusted 2005 dollars.<sup>45</sup> That is enough to buy a \$17,000 annuity – more than making up for their benefit reduction and *leaving them ahead by \$3,915 annually*.
- The Joneses make \$37,000 annually and retire in 2055. Like 95 percent of families today, they do not make enough money to contribute the maximum to their existing 401(k) or IRA. They have no additional money to contribute to this new tax-free savings account and get no tax benefits from it. As a result, they do not have any additional money to make up for the \$4,522 reduction in their Social Security benefit, *leaving them behind by \$4,522 annually*.

Expanded tax incentives, especially the Administration's Lifetime Savings Account proposal (LSAs) could even make middle-class families worse off if they lead businesses to drop their existing pension coverage, hurting middle-income Americans. One reason owners and executives of small businesses offer pensions to their employees is to take advantage of the tax-favored savings themselves. If they had alternative options for themselves, they would have less incentive to set up plans for their employees. According to an analysis by the Congressional Research Service, "some employers, particularly small employers, might drop their plans given the benefits of private savings accounts."<sup>46</sup>

In contrast, other proposals could enhance retirement security by overcoming obstacles to saving. Some proposals would not require any new tax incentives; they would simply make the process of saving easier and more automatic, overcoming a key obstacle to saving for many families. These proposals include making 401(k) contributions automatic and allowing taxpayers to split their tax refunds so that one part is deposited directly into an IRA.<sup>47</sup>

Alternatively, incentives for saving could be expanded. Currently, the saver's credit provides matching contributions for joint filers making up to \$50,000. This credit is scheduled to

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<sup>45</sup> A family making the maximum tax-free contributions to a balanced portfolio would have \$750,000. If the contributions had been taxable, the family would only have accumulated \$500,000. The difference is the cost of the tax cut.

<sup>46</sup> Jane G. Gravelle, Congressional Research Service, "Effects of LSAs/RSAs Proposal on the Economy and the Budget," January 6, 2004.

<sup>47</sup> See the Retirement Security Project at [www.retirementsecurity.org](http://www.retirementsecurity.org) for more details on these and other proposals.

expire in 2006. The credit could be extended and reformed to make it refundable and more effective. New research from the Retirement Security Project conclusively demonstrates that matching incentives encourage families to save more and that larger matches lead to more savings.<sup>48</sup> But the research also suggests that institutional changes, like a simple matching plan that deposits money directly into the savings account, can be an effective way to encourage savings. More work on translating this into policy is needed.

### C. Designing Proposals To Increase National Savings

Two features are essential in any plan to provide new incentives to raise national savings:

- First, the plan should be fully paid for without increasing the debt in the short run or the long run. Increased government borrowing, by itself, decreases national savings.
- Second, the plan should be targeted at encouraging genuinely new savings, not simply at rewarding existing savings.

RSA-style proposals fall short on both counts. They provide windfall tax breaks for people who are already saving and as a result do little to increase personal saving. And, if they are not paid for, RSA-style proposals result in increasing public dissaving over time. The net result is lower national savings, leading to a smaller capital stock and more foreign borrowing.

In contrast, pension reforms and savings incentives that make it easier and more affordable for middle-class families to save would help raise personal savings. And, if these proposals are fully paid for without increasing the deficit, they would also contribute to higher national savings.

## **IV. Conclusion**

Social Security faces a challenge and it is better to address this challenge sooner rather than later. But before tackling Social Security's long-term solvency we should mind the words of the Hippocratic Oath and first, do no harm. Carveout accounts would do substantial harm: they would reduce the solvency of Social Security and add trillions of dollars to the debt while making retirement less secure and potentially reducing national savings. Add-on accounts that are financed by increasing the debt – either in the short run or the long run – would also be counterproductive and harmful.

A balanced set of reforms that modestly increases Social Security's revenues while modestly decreasing benefits could ensure that Social Security is sustainably solvent. Such reforms would help reduce long-term budget deficits and increase national savings. A series of reforms could also help strengthen retirement security by making it easier for families to save.

Helping ensure that every American can have a stable and comfortable retirement must be foremost in our minds as we move forward to shore up Social Security for future generations.

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<sup>48</sup> Esther Duflo *et al*, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block," Retirement Security Project No 2005-5, May 2005.