

SOCIAL SECURITY REFORM CHECK LIST #2

Two Percent Personal Retirement Accounts

The Social Security Network is a project of The Century Foundation

Overview

Harvard economist Martin Feldstein, a former chairman of the Council of Economic Advisors, has proposed reforming Social Security by creating "two percent personal retirement accounts." Feldstein's proposal, unlike most other plans, seems painless. It imposes no reductions in Social Security benefits or increases in taxes. In fact, its most distinctive feature is the creation of a new benefit: a fully refundable income tax credit, equal to 2 percent of each worker's earnings subject to the Social Security payroll tax, that would finance new personal retirement accounts. (This tax credit is fully refundable because workers with no income tax liability and those who owe less than 2 percent of their earnings would still receive the full 2 percent contribution to their account.)

Under the plan, workers would have flexibility to choose from a group of regulated stock and bond mutual funds that would be administered by private managers. After retirement, however, every dollar a retiree withdraws from his or her personal account would reduce that retiree's guaranteed Social Security benefit by 75 cents. In cases where workers invested so badly or the market performed so poorly that little money was left in the accounts, they would continue to receive the benefits promised under today's system. Social Security's projected shortfall in the year 2037 would be deferred because the system would presumably owe less money to beneficiaries thanks to the accumulations in the investment accounts.

The Price-tag

According to the Congressional Budget Office, which recently released a critique of the Feldstein plan, the proposed tax credits would cost the government about \$800 billion over the next ten years. Rather than raise taxes or reduce government spending over that period, Feldstein proposes allocating anticipated federal budget surpluses to pay for the tax credit. Whenever federal surpluses become insufficient, then Congress would determine how to raise the money. But for the near future, Feldstein argues, his proposal could be implemented without imposing either benefit reductions or revenue increases that other plans for strengthening Social Security include:

Since Social Security faces a projected shortfall in 2037, can the system really be strengthened painlessly? The Feldstein plan appears to do so by financing the new accounts with the surplus in general revenues, as opposed to the payroll tax that is dedicated to Social Security benefits, thereby tapping a new well of resources for mandatory retirement savings. But because current federal budget surpluses reduce the federal debt, creating a new tax credit and diverting the surpluses to private accounts would increase the government's long-term obligations and interest costs. Therefore, as the Congressional Budget Office report stated, "The policy would implicitly increase the tax burden on future workers if no further adjustments were made on the spending side of the budget."

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Evaluating the Plan

To assess the impact of various proposals to change Social Security, The Century Foundation organized a group of experts to develop principles for prudent reform. Here's how the Feldstein proposal for 2 percent personal retirement accounts stacks up against those principles:



Principle 1

Social Security should continue to provide a guaranteed lifetime benefit that is related to past earnings and kept up-to-date as the general standard of living increases.

Analysis: Under the Feldstein plan, guaranteed Social Security benefits under the current formula, which is based on past earnings and takes into account cost-of-living changes, would become the minimum that workers receive. The actual payments that workers would collect, however, would depend to a significant extent on how the investments in their personal retirement accounts fared. Because the personal retirement accounts would be financed through a flat-rate income tax credit of 2 percent, the dollar amount of the contributions to the accounts would be higher for workers with larger incomes and would rise over time as a worker's earnings grew. Therefore, a retiree's total benefits would continue to be related to past earnings, although less so than under current law because of variations in the investment performance of his or her account.



Principle 2

American workers who have the same earnings history and marital status, and who retire at the same time, should receive the same retirement benefit from Social Security.

Analysis: The Feldstein 2 percent plan would produce new disparities in benefits earned by retirees with the same earnings history and marital status because some workers could be expected to make better investments than others. Variations in investment performance would be somewhat limited, however, because every extra dollar that workers accumulate in their personal retirement accounts would increase the benefits they receive by just 25 cents under the plan's formula. Distributions would be further reduced by the cost of administering the accounts, paying investment management fees, and integrating them with the rest of the Social Security system. Economist Peter Diamond has shown that the administrative costs in countries that have set up individual accounts (Britain, Chile, Argentina, Mexico) reduce benefits by 20 to 30 percent compared to what the U.S. Social Security system would pay given the same resources.



Principle 3

Social Security benefits should continue to be fully protected against inflation, and beneficiaries should continue to rest assured that they will not outlive their monthly Social Security checks.

Analysis: Because the baseline benefit would remain intact, beneficiaries would continue to receive some lifetime benefit. To date, however, the Feldstein 2 percent personal account plan does not specify whether and how the amounts accumulated in personal accounts would be converted into monthly payouts. Even if beneficiaries were required

to annuitize their accounts (that is, convert the lump sums into smaller periodic payments based on life expectancy levels), the value of those payments would be eroded by inflation unless they were indexed to increases in the cost of living, as are today's Social Security benefits. The Feldstein plan does not indicate that the payments would be adjusted for inflation, however. If retirees were allowed to withdraw the money in a lump sum, as they can with individual retirement accounts, for example, they might spend all that money before they die.

 **Principle 4**

Retirees who earned higher wages during their careers should continue to receive a larger check from Social Security than those with lower incomes; but the system should also continue to replace a larger share of the past earnings of low-income workers.

Analysis: When the payouts from personal retirement accounts are included, the overall effect of the plan would be that higher earners would receive disproportionately greater increases in their total benefit package than lower earners. Brookings Institution economists Henry J. Aaron and Robert D. Reischauer show that a worker with a high income would see their combined Social Security and private account payment increase by more than twice that of a low-income worker.¹ That would happen mainly because 1) contributions to the accounts would be made at the same 2 percent rate regardless of income, but 2) guaranteed benefits, which would be reduced at the same rate for all retirees, replace a larger share of the past earnings of low-income workers. These calculations don't factor in the probability that high income workers would invest more aggressively and successfully. The bottom line is that lower-income workers would benefit less from the proposed formula than upper-income workers. (Feldstein has said that this problem could be addressed by imposing a modest redistributive tax on the investments of higher earners).

 **Principle 5**

Social Security's insurance protections for American families, including disability insurance, should be fully sustained.

Analysis: The Feldstein 2 percent account plan is not explicit about what changes, if any, would be made to the survivor's and disability features of Social Security. By skirting this issue, the plan leaves important questions unanswered. For example, if a worker died prematurely and left dependents, what formula would be used for paying out the proceeds of his or her personal retirement account and integrating these funds with Social Security survivor's benefits? If workers became disabled, would they be entitled to gain access to the investments accrued in their accounts?

1. In the table below, Social Security benefits correspond approximately to the average replacement rates of low and maximum earners--56 percent and 25 percent, respectively. Each worker contributed proportionately to individual accounts and, therefore, receives a pension proportionate to earnings. When Social Security benefits are reduced by three-quarters of the pension based on the individual account, the low earner's pension goes up 12 percent, and the high earner's by 21 percent.

	Average Earnings	Social Security	Individual Account	Total Pension	Change in Pension
Low Earner	1,000	560	240	620	+ 11%
High Earner	5,600	1,375	1,340	1,720	+ 25%



Principle 6

Social Security's long-term financing problem should not be aggravated by diverting the program's revenues to private accounts, and benefits should not be reduced to make room for private accounts; any such accounts should be supplementary to Social Security, entirely as an add-on.

Analysis: By creating a new refundable income tax credit to finance personal accounts, the Feldstein plan avoids, for now, diverting payroll tax revenues earmarked for current benefits and the Social Security trust funds. But because the tax credit would create a new long-term government obligation, future Congresses would need to find a way to pay for the personal accounts when and if surpluses run out. One inviting target at that point would be the Social Security trust funds themselves, which are projected to have accumulated over \$2 trillion by early in the next century to finance guaranteed payments to the baby boomers. Any shifting of assets from the trust funds to private accounts would reduce the money available to pay for guaranteed benefits in the future. Another "fix" would be for Congress to allow the national debt to grow to keep the program whole.



Principle 7

In addition to securing Social Security as the foundation of income support for retirees, their dependents, the disabled, and survivors, more needs to be done to encourage private savings and pensions.

Analysis: Initially, the Feldstein plan would neither increase nor decrease America's low levels of national savings, which many economists believe should be raised to promote investment and long-term economic growth. Every federal surplus dollar shifted to investment in a personal account would remain a dollar saved. To gauge the effect of the plan on national savings when and if surpluses run out, one would need to predict what actions Congress would take in the absence of the plan--which obviously are unknown. Professor Feldstein assumes that, without his plan, Congress would spend any anticipated surpluses. Under that assumption, his plan would increase savings and, consequently, economic growth. But the Congressional Budget Office argues, at least as plausibly, that the new accounts would lead to higher government budget deficits and lower national savings because they constitute a new, costly, and unlimited commitment of federal resources.

Moreover, if the government guarantees prevailing Social Security benefits as a baseline regardless of how well each worker's personal account performs, it risks encouraging workers to take greater, perhaps imprudent risks with their investments than they otherwise might. Under that scenario, akin to the savings and loan debacle of the 1980s, the government's future obligations would be even greater.

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