SOCIAL SECURITY REFORM CHECK LIST #5

The Gramm Plan

Overview

Senator Phil Gramm (R-Tex) is sponsoring a plan to transform Social Security by diverting nearly one-fourth of the payroll taxes that finance today's retirement insurance system into individual investment accounts. Under his proposal, workers would have the option of either retaining their current Social Security coverage and benefits or electing to shift three percentage points of their 12.4 percent Social Security payroll tax (split equally between workers and their employers) into their own investment account. Workers would not be allowed to opt out of the system altogether or transfer a different share of their payroll tax into the accounts. Those who opted for the investment accounts would be allowed to invest that money in a selection of privately managed mutual funds that would be certified and regulated by a new government oversight board. Initially, the accounts would be restricted so that no more than 60 percent of an investment portfolio could be in stocks, which can decline precipitously in value.

Upon retirement, workers with investment accounts would be required to convert the accumulated assets into an annuity that, like today's Social Security, would provide a lifetime monthly payment that increases as inflation rises. After the system was fully phased in, retirees who opted for the personal accounts would be guaranteed a total monthly benefit equal to the guaranteed payment promised under today's system, plus 20 percent. If the assets accumulated in a retiree's personal account proved to be insufficient to pay the full 20 percent bonus, the government would make up the difference. Retirees who invested more successfully would be entitled to cash out any accumulations in excess of the 20 percent bonus as a lump sum if they wanted to.

Senator Gramm claims that his plan would end prospects that Social Security will face a shortfall in the year 2032, when payroll taxes combined with system's trust fund assets are expected to become insufficient to pay guaranteed benefits in full. The main reason is that the assets accumulated in the private accounts would significantly reduce the benefits that the system would have to pay out from the remaining 9.4 percent payroll tax and the assets in the Social Security trust funds.

The Price-tag

Diverting three percentage points of the Social Security payroll tax into private accounts for every worker who makes that choice would significantly reduce the anticipated growth in the Social Security trust funds, which currently are expected to tide the system over from 2013 to 2032--a period when promised benefits are expected to exceed payroll tax revenues. Because current retirees will have no private accounts to draw on and older workers will have little time to accumulate much in their private accounts, maintaining today's guaranteed benefits for them while payroll tax revenues decline by up to 24 percent (depending on how many workers opt for the new system) poses an expensive transition challenge.

The Century Foundation, formerly the Twentieth Century Fund, is a research foundation that undertakes timely and critical analyses of major economic, political, and social institutions and issues. Nonprofit and nonpartisan, TCF was founded in 1919 and endowed by Edward A. Filene.

(212) 535-4441 • info@tcf.org • http://www.tcf.org
41 East 70th Street • New York, NY 10021

Stephen C. Goss, deputy chief actuary of the Social Security Administration, calculates that if all workers opted for the private accounts, the cost to the federal budget and the Social Security trust funds would be an average of $140 billion a year from 2000 to 2009. Senator Gramm has said that those transition costs could be paid out of projected federal budget surpluses. Drawing on surpluses poses problems, however. First, surpluses are projected to be adequate to pay for only $81 billion of the $140 billion that would be needed. Second, if the projected surpluses were to be used to finance the transition to the new retirement system, actual surpluses would be substantially lower each successive year because the surplus from the previous year would not have been used to reduce the federal debt and thereby reduce interest obligations. Third, the projected federal budget surpluses through 2007 are almost entirely attributable to the surpluses in the Social Security trust funds. So paying for the transition with budget surpluses essentially means depleting 72 percent of the Social Security trust funds, which would raise the level of government debt.

Senator Gramm projects that it would take 32 years before his plan would become financially self-sustaining and 50 years before the assets accumulated in individual investment accounts would be sufficient to generate a benefit equal to 20 percent above the level promised by the existing system. If the investments in the private accounts don't increase in value as rapidly as Senator Gramm predicts--5.5 percent annually over and above the inflation rate--the system's long-term financial burdens could increase rather than decrease. Senator Gramm also claims that the government would gain additional revenues from higher corporate tax collections attributable to increased corporate profits that would arise from more money flowing into capital markets through the private accounts. There is little historical evidence, however, that higher levels of market capitalization generate increased corporate profits.

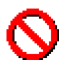
Evaluating the Plan

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 Senator Gramm's proposal 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.

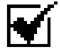
> **Analysis:** Guaranteed Social Security benefits under the current formula, which are based on past earnings after taking into account cost-of-living changes, would remain the minimum that workers would receive if they decided against opening their own accounts. If they opted for the accounts, they would be guaranteed a 20 percent bonus on top of a benefit that would still be based on past earnings. And because the personal retirement accounts would be financed through a 3 percent flat-rate contribution, the dollar amounts flowing into the accounts would be higher for workers with larger incomes and would rise over time as a worker's earnings grew. Workers who invested so successfully that they could collect even more than the 20 percent bonus would receive benefits less proportionate to past earnings, however.



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*:** Workers who elect to open private accounts gain a guaranteed 20 percent benefit bonus above the amount that those who declined the option would receive. So the same past earnings history and marital status would not lead to identical benefits for workers who 1) made different decisions about whether to open an account and 2) had different degrees of investment success. Those who earned more than the 20 percent bonus in their accounts would be able to collect the difference as a lump sum.



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*:** The Gramm plan stipulates that the accumulations in the personal investment accounts would be required to be converted to lifetime, inflation-adjusted annuities akin to current benefits, and that those payments would be a minimum of 20 percent higher than the benefits currently promised. Although many questions could be raised about whether the plan adequately accounts for the cost of financing those benefits, the proposal adheres to this particular principle. An important ambiguity about the plan remains, however: it is unclear what benefits surviving spouses would receive. Under current law, survivors receive 100 percent of the benefit that their late spouse collected (presuming that benefit was higher then the payment the survivor was previously entitled to). The Gramm plan, as summarized to date, does not specify what happens upon the death of a beneficiary.

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*:** Workers whose private accounts grow enough to provide more than the 20 percent guaranteed bonus would receive larger payments relative to their past earnings than those who invested less successfully. In all probability, the most prosperous investors will be clustered at high income levels because 1) they have much greater experience and familiarity with investing, 2) they would have more money in their accounts to build on (since the contributions are a flat 3 percent rate), and 3) low-income workers with no investment experience may be more reluctant to open accounts in the first place.

Principle 5

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

***Analysis*:** The Gramm plan stipulates that the survivor's and disability insurance features of the current system would be preserved in full. But Social Security

actuary Stephen Goss points out that the proposal allocates only 1.5 percentage points of the 12.4 payroll tax toward maintaining those protections, even though that insurance now costs the system about twice as much--3 percentage points. Because the plan does not provide an explanation of how current disability and survivor's insurance could be maintained on half the funding it now receives, that aspect of the proposal deserves further scrutiny.

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 diverting 3 percentage points of the payroll tax financing the current system into private accounts, for those who choose them, the Gramm plan compounds the challenge of alleviating the long-term financial pressures on Social Security. Because current retirees and those now near retirement age must continue to receive promised benefits from payroll taxes in the years ahead, the cost of creating the new accounts will, in essence, deplete the Social Security trust funds and the federal budget surplus while increasing the national debt and government interest costs. Although the accumulations in the investment accounts after several decades might indeed be sufficient to finance the more generous benefits proposed, that eventuality depends on a variety of uncertainties about the number of workers who opt for the accounts, the performance of the economy, and investment growth. In any case, no one disputes that the cost of making a transition to Senator Gramm's system would add to federal budgetary pressures.

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*:** At first blush, the Gramm plan would seem to neither increase nor decrease national savings because payroll taxes would be moved from one category of savings--the Social Security trust funds--to private savings in the form of the personal accounts. But because of the need to finance the transition to the new system, the government will either have to borrow more, reduce promised Social Security benefits, or increase taxes. Increased federal borrowing by definition is the same as reduced government savings. And either reducing Social Security benefits or increasing taxes would cut the amount of money available to households to save.

The government guarantee of a 20 percent bonus above today's benefits for those with investment accounts--even those that perform poorly-- 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 could skyrocket since the bonus would be guaranteed whether the money was there or not.

12/10/98