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

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Executive Summary

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

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

The Social Security Trust Fund and National Saving

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

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

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

- The commission argues that 2016 is the "crisis date" for Social Security, because under current projections, benefit payments in that year will exceed payroll revenue (which does not count the interest earned on the Trust Fund's assets). If the Trust Fund held no assets, 2016 would indeed be a particularly important date for Social Security. But the Social Security Trustees currently project that in 2016, the Social Security Trust Fund will contain reserves of more than $5 trillion (which is more than $3 trillion in today's dollars) and will be earning more than $300 billion a year on those assets. The commission's arguments regarding the relevance of 2016 are misguided

because the Trust Fund provides resources to the Social Security system and — more fundamentally — because the accumulation of reserves within the Trust Fund has raised national saving and thereby eased the burden of financing future Social Security benefits. In addition, if 2016 were indeed a "crisis year" for Social Security, shifting two percentage points of payroll into individual accounts would *accelerate* the crisis from 2016 to 2007, nine years earlier than under current law.

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

Social Security and Progressivity

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

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

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

Americans and Hispanics receive *higher* average rates of return than white Americans (primarily because of their lower earnings), a finding that the commission document fails to report.

Bequests and Wealth

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

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

Rate of Return

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

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

Introduction

On July 19, President Bush's Social Security reform commission released a draft of its interim report, in preparation for its second public meeting on July 24. The commission staff earlier prepared background materials for the first commission meeting on June 11. Together, the commission documents — the draft interim report and the staff background materials — provide insight into the arguments and ultimate recommendations likely to be advanced by the commission.

Unlike members of the commission, all of whom are on the record as supporting individual accounts, we are four economists with expertise on Social Security who remain skeptical about individual accounts. This document provides members of the media, policy-makers, and the interested public with our analysis of the arguments presented in the commission documents. As this analysis indicates, we find that the draft interim report contains a number of misleading statements and factual errors that invite misinterpretation and are likely to sow confusion.

We begin with a one-page summary of some of the most misleading statements in the draft interim report. Some basic background information on Social Security and individual accounts follows. We then provide brief analyses of the arguments contained in the commission documents regarding:

- The assets of the Social Security Trust Fund
- The significance of 2016 and 2038 in the Social Security debate
- National saving, Social Security, and individual accounts
- Redistribution under Social Security and individual accounts
- Bequests, wealth, and individual accounts
- The rate of return under individual accounts and Social Security
- The baseline used to evaluate Social Security proposals

For more information about the impact of individual accounts on Social Security, please see the web sites of the Center on Budget and Policy Priorities (http://www.cbpp.org) and the Century Foundation's Social Security Network (http://www.socsec.org).

Fact and Fiction in the Bush Commission's Draft Interim Report

The draft interim report includes a number of misleading or incorrect statements, including:

Assertion: In "15 years," "the very same crisis" as occurred in 1983 "will recur." [Page 2]
Fact: In 1983, the Social Security Trust Fund was nearly exhausted. The Social Security Trustees currently project that in 2016, the Social Security Trust Fund will contain reserves of more than $5 trillion (which is more than $3 trillion in today's dollars). [See section on the significance of 2016.]

Assertion: "Rather than ending with the life of the beneficiary, it [an individual account system] can be a means of wealth accumulation and long-range investmentY."[Page 4]
Fact: The assertion that the existing Social Security program provides no resources to surviving relatives of an individual who dies is simply wrong. Social Security provides benefits to surviving spouses, children, and parents of deceased workers. In 1999, some $75 billion — roughly 20 percent of all Social Security benefits — were paid to such survivors. [See section on bequests and wealth.]

Assertion: "The existing Social Security program does not save or invest for the future." [Page 5]
Fact: In legislation enacted in the late 1970s and early 1980s, Congress set Social Security payroll taxes higher than necessary to pay for current benefits. The payroll taxes in excess of current benefits contributed to national saving, because they reduced government borrowing from the public and enabled the government to reduce the public debt. Official statistics compiled by the Bureau of Economic Analysis document that Social Security surpluses are contributing to national saving. Furthermore, national saving would be no higher - and may well be *lower* - if Social Security revenue were diverted into individual accounts. [See sections on the assets of the Social Security Trust Fund, the significance of 2016, and national saving.]

Assertion: "Despite popular perceptions, recent studies show that Social Security provides little, if any, systematic redistribution from rich to poor." [Page 6]
Fact: Social Security is progressive, despite the lower life-expectancies of low earners, because the benefit formula favors lower earners. Furthermore, recent studies demonstrate that Social Security is becoming *increasingly* progressive over time, a finding that the commission report ignores. In contrast, most individual account proposals would be regressive. They start with a benefit formula that is proportional to earnings, rather than being disproportionately beneficial to those with lower earnings. Once the longer life expectancies of higher earners are taken into account, such proposals become *regressive* on a lifetime basis. [See section on redistribution.]

Assertion: "African Americans receive nearly $21,000 less on a lifetime basis from Social Security's retirement program than whites with similar income and marital status." [Page 6]
Fact: The statement is misleading because it compares an African-American and white American *at the same earnings level*, even though African-Americans tend, on average, to have lower earnings and therefore to benefit disproportionately from Social Security's progressive benefit formula. Indeed, the study cited on this matter by the commission finds that when life expectancies *and* earnings are taken into account, the average rate of return on Social Security is modestly higher for African-Americans than for whites and much higher for Hispanics than for whites. [See section on redistribution.]

Background on Social Security's Long-term Deficit And Individual Accounts

- Under current law, the Social Security system faces a projected long-term imbalance of 1.86 percent of taxable payroll, or 12 percent of projected outlays, over the next 75 years. According to current projections, annual Social Security tax revenue (which does not include interest on the bonds the Trust Fund holds) will fall below Social Security benefit expenditures in 2016. In 2025, *total* Social Security revenue (including interest earned by the Social Security Trust Fund) will fall below benefit costs, and the Trust Fund will begin to redeem its bonds. The Social Security Trust Fund will be exhausted in 2038, at which point tax revenue will be sufficient to pay for about 70 percent of current-law benefits.

- To restore Social Security's long-term financial balance, three options exist:

  - Increase revenue (either by raising Social Security taxes or by transferring funds from the rest of the budget to Social Security),
  - Reduce benefits, or
  - Raise the returns earned on the Social Security Trust Fund.

  Individual accounts, in and of themselves, do nothing along any of these three dimensions and thus do not directly improve Social Security's financial condition. Rather, individual account advocates typically argue that the income from such accounts would offset at least part of the accompanying reductions in traditional Social Security benefits.

- Contributions to individual accounts could be financed either by transfers from the non-Social Security budget or by diverting revenues from the Social Security Trust Fund. The new tax law, in combination with other priorities reflected in the Congressional budget resolution, has essentially consumed all of the previously projected surpluses in the non-Social Security budget. As a result, any attempt to transfer funds out of the non-Social Security budget to create "add on" accounts (that are added on top of existing Social Security revenue) would cause large deficits outside of Social Security and Medicare.

- The alternative is to finance "carve out" accounts from existing Social Security revenue. This approach seems most consistent with President Bush's Social Security principles.

- Diverting revenue from Social Security into individual accounts would exacerbate Social Security's projected long-term deficit by reducing the revenue available to the system. For example, if payroll taxes equal to two percent of wages were diverted from the Social Security Trust Fund into individual accounts, and if no other changes were made, the Trust Fund would be exhausted in 2024 rather than in 2038.

- Restoring long-term balance to the Social Security system while diverting revenue from the Trust Fund to individual accounts requires large reductions in Social Security benefits (relative to the

benefits that would be paid under the current-law benefit formula). In an analysis we conducted last year for the Century Foundation, we examined the size of the required reductions and concluded that younger workers would experience traditional benefit reductions of more than 50 percent (see box below). Including the income from individual accounts, the combined retirement income (the reduced Social Security benefits plus the retirement income from the individual accounts) for such workers would be 20 percent below current-law levels.

- In short, carve-out accounts would involve politically unappealing reductions in Social Security benefits. Add-on accounts might have proven to be more politically attractive, but they would create large deficits in the non-Social Security budget, given the tax cut recently signed into law.

Benefit Reductions under Social Security under Carve-out Individual Accounts: A Summary of the June 2000 Century Foundation Report[1]

President Bush has promised to protect benefits for current retirees, older workers, survivors, and the disabled. Protecting such benefits while diverting two percentage points of payroll into individual accounts and also eliminating the 75-year deficit within Social Security would require traditional benefit reductions (relative to current law) that *average* more than 40 percent.[2]

Such across-the-board reductions in traditional benefits would impose greater burdens on older workers (who would have less time to build up their individual accounts) than younger workers. To avoid a sharp reduction in retirement income for older workers, the reductions in Social Security benefits would almost certainly be phased in slowly.

Under one plausible approach for phasing in the benefit reductions, Social Security benefits would have to be reduced by 29 percent for those who are aged 50 in 2002 and by 54 percent for those aged 30 or younger, relative to the benefit levels they would receive under the current benefit structure. To be sure, income from individual accounts would offset some of these benefit reductions. But a large net benefit reduction would nonetheless occur, unless the rate of return on private accounts was extremely high (much higher than even individual account supporters predict).

[1] Henry J. Aaron, Alan S. Blinder, Alicia H. Munnell, and Peter R. Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation and the Social Security Network, June 6, 2000.

[2] To see why benefit reductions of about 40 percent or more would be required, note that Social Security is projected to cost an average of 15.4 percent of payroll over the next 75 years. The projected long-term deficit is just under 2 percent of payroll. Diverting two percentage points of payroll into individual accounts would raise the long-term deficit to almost 4 percent of payroll. The protected benefits (for current retirees, near retirees, and the disabled) amount to about 6 percent of payroll, leaving 9.4 percent (15.4 percent minus 6 percent) available to be reduced. Eliminating a deficit of 4 percent of payroll when the available benefits that could be reduced amount to 9.4 percent of payroll requires more than a 40 percent average reduction in benefits.

For example, if the average rate of return on the stock market in future decades equals the average rate of return from past decades, the average combined retirement income from Social Security and an individual account for single individuals with average earnings who are 30 years old in 2002 (and retire at age 65 several decades from now) would be 20 percent below the level they would receive from Social Security under the current benefit structure.

The Assets of the Social Security Trust Fund

Commission Perspective

The commission asserts that the Social Security Trust Fund does not hold real assets. In particular, the draft interim report argues that "the Trust Fund has not accumulated reserves of wealth" and claims that the Social Security Trust Fund is not an asset.[3] Even the Secretary of the Treasury is reported to have said "Today we have no assets in the trust fund." The draft interim report also quotes from several respected non-partisan sources, which the report implies offer support for its argument that the Trust Fund does not hold real assets.[4]

Analysis

The Social Security Trust Fund currently holds more than $1 trillion in Treasury securities. These assets are backed by the full faith and credit of the U.S. Government, which is widely respected in the global financial markets as providing the benchmark of security for any financial asset. The Treasury bonds held by the Social Security Trust Fund are every bit as "real" as the Treasury bonds held by private investors. Asserting that the Trust Fund's bonds are worthless sets a dangerous precedent, by calling into question the U.S. Government's iron-clad commitment to honor its debt obligations.

The commission's draft interim report conflates two issues: whether the bonds held by the Trust Fund are assets to the Social Security system, and whether they are assets for the government as a whole. The first question is unambiguous: The bonds held by the Trust Fund are an asset to the Social Security system because they earn interest income and, if necessary, can be redeemed to pay benefits. The fact that these bonds are "paper" assets does not in any way reduce their value. *All* pension funds hold paper IOUs; so would the individual accounts that the commission favors. The value of all paper assets depends on the willingness of someone to redeem them. The bonds held by the Trust Fund are, if anything, *more* secure than other paper assets, given their U.S. Government backing.

The second issue, whether the accumulation of the Trust Fund assets has improved the capacity of the U.S. government as a whole to meet future obligations, is more subtle. As we explain in the next section (on the significance of 2016 and 2038 in the Social Security debate), the Social Security program *has* contributed to national saving by accumulating reserves. Such increased saving will make it easier for the government to meet its future obligations. The simple fact is that if we save more today, we will be richer tomorrow and better able to meet obligations of all kinds.

It is important to note that the commission's quotations from non-partisan experts involve only this second issue — the degree to which the Trust Fund has contributed to the ability of the government as a whole to finance future obligations — and *not* whether the Trust Fund represents an asset to the Social Security system. The quotations do not address the issue that the commission report implies they do. None of the quotations states that the bonds held by the Trust Fund are worthless to the Social Security system.

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[3] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 14.

[4] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 17.

Indeed, the Government Accounting Office's quotation (included in the commission document) explicitly notes that the Trust Fund's "securities are an asset to the Trust Fund…"[5]

Background

The bonds held by the Trust Fund are legally backed by the full faith and credit of the U.S. government. Such bonds cannot be regarded as worthless if the nation's pension fund (the Social Security Trust Fund) holds them but as extremely valuable assets if private investors hold them.

All pension funds — including the individual accounts that the commission advocates — hold "paper assets" in their portfolio. In other words, they all hold IOUs, or the written promises of some public or private entity. Aside from the few who hold gold or silver bullion in their vaults, none holds "real assets." Individual accounts would similarly hold paper IOUs. Indeed, under a system of individual accounts, many individuals would likely hold Treasury bonds in their accounts.

The value of all paper assets depends on the willingness of someone to redeem them. As explained in the next section, the government will *eventually* have to raise taxes or reduce spending to pay interest on, or to redeem, the Treasury bonds held by the Trust Fund (just as it will with regard to the bonds that private investors and other pension funds hold). But the government will be in a better position to raise revenue or otherwise find additional room in the budget to redeem the bonds because the accumulation of Social Security reserves has added to national saving, reduced the public debt and thereby reduced the annual cost of paying interest on that debt, and promoted economic growth.

Henry Aaron and Robert Reischauer on "Are The Trust Funds Real?"

"Some analysts have claimed that Social Security and Medicare reserves are just accounting mechanisms and that the trust funds hold only 'paper' assets. They sometimes claim that the accumulation of large trust fund balances does nothing to improve the government's ability to pay future benefits and that they are available only in 'a bookkeeping sense.' This view is simply wrong....

"The statement that Social Security reserves are only 'paper assets'...is false in substance. Neither Social Security nor private financial savers, including individuals and pension funds, hold 'real' assets in their accounts. Both hold IOUs — paper promises of some private or public entity to pay interest or dividends. In either case, the assets are only as good as the willingness and ability of someone to redeem the assets or buy them before maturity. The only difference between reserves of Social Security and those of private savers is that Social Security's reserves consist entirely of 'gilt-edged' federal securities, because U.S. law allows Social Security trustees to invest only in securities guaranteed as to principal and interest by the federal government....

"But to consider the stock certificates or bonds of some blue-chip corporation — recall the Penn Central saga — let alone the inflated shares of dot.com or biotech startups that have never turned a profit and have few tangible possessions — to be 'real' assets and the government securities held in Social Security's reserves not to be 'real' is preposterous. Not only does the government have the means to pay its obligations that is unmatched in the private sector, it also has the will, buttressed by political pressures. It is inconceivable that lawmakers would allow the government to renege on its financial promises to redeem bonds held by the trust fund especially when the Social Security surpluses have helped to pay down the national debt, increased national saving and investment, and expanded the nation's productive capacity, making it easier to meet these obligations. Social Security reserves are therefore every bit as real as those held by any private pension fund, personal brokerage account, or corporate reserves."

Source: Henry Aaron and Robert Reischauer, *Countdown to Reform: Key Issues in the Social Security Debate* (The Century Foundation), pages 51-52.

[5] Ibid.

The Significance of 2016 and 2038 in the Social Security Debate

Commission Perspective

According to the Social Security actuaries, projected Social Security tax revenue (which does not include the interest earned by the Trust Fund on the bonds it holds) will fall short of projected benefits in 2016. Because of the reserves it will have accumulated by 2016, however, the Trust Fund will be able to pay full benefits for 22 years after that date and is not projected to be exhausted until 2038.

The commission holds that 2016 is a more significant date for Social Security than 2038. In particular, the draft interim report asserts that "the Trust Fund has not accumulated reserves of wealth" and that "when Social Security begins running cash deficits in 2016 and must begin redeeming the Fund's bonds, the nation will face the same difficult choices as if there had been no Trust Fund at all."[6] The staff background documents argue that after 2016, a Trust Fund with substantial holdings "does not mean that the government has real economic resources at its disposal" with which to pay Social Security benefits.[7]

Analysis

If the Trust Fund held no assets, 2016 would indeed be an important date because Social Security benefit payments would exceed the system's financial resources. But, as explained in the previous section, the Trust Fund does hold assets.

The commission's argument that the Trust Fund does not affect the government's ability to pay Social Security benefits in the future ignores the fundamental economic contribution the Trust Fund makes. The Trust Fund balance records the taxes in excess of benefit payments that working people have paid since the late 1970s (plus the interest on those excess taxes). These cash-flow surpluses have raised national saving and investment and thus have helped to expand national income. They have thereby bolstered our ability to pay Social Security benefits in the future (see the section on national saving below). The commission's argument to the contrary is misguided because it assumes that Social Security's cash-flow surpluses, reflected in the Trust Fund's balances, contribute *nothing* to national saving. This assumption is flatly inconsistent with the treatment of Social Security in the national income accounts, which are the official source of data on national saving. This assumption also is contradicted by historical experience and is entirely implausible now given the existence of a lock-box for Social Security.

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[6] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 16.

[7] President's Commission to Strengthen Social Security, Background Materials for June 11 meeting, Section 1.B.2.

Background

The Trustees of the Social Security Trust Funds (including three members of the President's Cabinet — Treasury Secretary O'Neill, Labor Secretary Chao, and Health and Human Services Secretary Thompson) project that under current law, the Trust Funds will be exhausted in 2038, not 2016. That is, a combination of payroll taxes and assets in the Trust Fund are projected to be sufficient to pay full benefits until 2038; after 2038, Social Security taxes will provide enough money to cover about 70 percent of promised benefits.

Staff documents prepared for the Social Security commission argue that 2016, rather than 2038, is the most important date. In 2016, promised Social Security benefits will begin to exceed annual Social Security payroll tax collections. But the Social Security Trustees project that Social Security will run an overall surplus of more than $250 billion in 2016, because taxes are not the sole source of Social Security income. The Social Security system will also receive more than $300 billion in interest on its bonds in 2016, producing an overall surplus in the system when the interest income is included. Such overall surpluses will continue until 2025, at which point the system will begin to draw down its accumulated reserves (i.e., it will begin to redeem the bonds it holds). Using these reserves along with incoming payroll revenue, the Social Security system will continue to be able to pay full benefits until 2038.

The commission documents argue that 2038 is an illusion, because the Treasury securities held by the Social Security Trust Fund are not "real" assets for the government as a whole and hold no economic significance. But the Trust Fund assets do hold significance. They reflect Congressional decisions in the late 1970s and early 1980s to convert Social Security from a pay-as-you-go system to a system partially funded in advance. To build up reserves, Congress set payroll taxes higher than was necessary to finance current benefits. Those reserves currently amount to approximately $1 trillion. They are projected to reach more than $5 trillion ($3.3 trillion in today's dollars) by 2020. These reserves have contributed to national saving, because they have reduced the government's borrowing from the public and now are enabling the government to reduce the public debt substantially.

Such "saving through the Trust Fund" benefits the economy in the same manner that saving through 401(k) plans or other private vehicles does. Government saving, like private saving, increases investment and the amount of capital available per worker. Higher investment means more capital for each worker and higher national production and national income. And increased national income will ease the burden of supporting a growing aging population. In this way, the very real sacrifice of today's workers in contributing more in payroll taxes than is needed to support today's retirees has boosted investment and enhanced our capacity to pay future Social Security benefits. The balance in the Trust Fund thus is both an asset to the Social Security system and a reflection of the economic contribution that the partial advance funding of Social Security has made to national saving.

The commission's draft report asserts that the partial funding of Social Security has not contributed to greater national saving because the government as a whole ran a budget deficit in the 1980s and early

1990s.[8] This assertion ignores the fact that reducing a budget deficit adds as much to national saving as increasing a surplus. In other words, if the non-Social Security portion of the budget had a deficit of $300 billion in a given year, and Social Security ran a $100 billion surplus, the net deficit would be $100 billion smaller — and national saving $100 billion higher — than otherwise. The only way in which Social Security surpluses would fail to increase government saving is if Congress decided to increase spending or reduce taxes in the non-Social Security part of the budget *because of* the surplus in Social Security. There is little evidence that such offsets have occurred to any significant degree since the mid-1980s, and they are now extremely unlikely given the "lock-box" on Social Security's cash-flow surpluses included in the Congressional budget resolution. The assets held by the Trust Fund thus largely, if not entirely, reflect a net addition to national saving. In any case, the draft interim report implicitly assumes that *none* of Social Security's cash-flow surplus contributes to national saving, an extreme position that is simply not tenable.

To be sure, the government will *eventually* have to raise taxes or reduce spending to pay interest on, or to redeem, the Treasury bonds held by the Trust Fund. This fact does not make those bonds any less valuable. If the pension funds of General Motors or IBM hold government bonds and cash them in, the Treasury also will have to raise funds to pay them off (and clearly will do so). The key point is that the government will be in a better position to raise revenue or otherwise find additional room in the budget to redeem bonds because the accumulation of Social Security reserves has added to national saving, reduced the national debt, and promoted economic growth. From a narrow budget perspective, the reduction in public debt produced by the Social Security surpluses also lowers future interest payments on the public debt. Such reduced interest payments on the public debt make it easier to finance future Social Security benefits.

Finally, it is worth noting that if 2016 were a "crisis year" for Social Security, shifting two percentage points of payroll into individual accounts would accelerate the crisis from 2016 to 2007, nine years earlier than under current law.

The Clinton Administration's Views on the Social Security Trust Fund

The draft interim report quotes from the Clinton Administration's FY 2000 budget as support for its argument that the Trust Funds do not hold real assets, making it appear as though the Clinton Administration shared that view.[9] But the passage cited by the commission is a paragraph from a technical document accompanying the budget that is normally prepared at a staff level and that senior Clinton Administration officials immediately corrected when the FY 2000 budget was published.[10]

[8] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 16.

[9] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 16.

[10] Testimony of Jacob Lew, "President's Proposed Budget for Fiscal Year 2000," U.S. Senate Committee on the Budget, February 2, 1999, page 360.

Furthermore, the commission documents omit the fact that in the FY 2001 budget, the Clinton administration set forth a corrected, and more accurate, characterization of the Trust Funds. The FY 2001 Budget stated: "Increases in trust fund balances *do* strengthen the ability to pay future benefits if the surplus in the trust fund is matched by an improvement in the Government's net financial positionYIf a trust fund surplus is matched by a corresponding reduction in publicly held debt, then the Government's financial position will be improved."[11]

By selectively quoting from a technical passage that was outdated but had been overlooked by senior Administration policy-makers, and by failing to acknowledge the subsequent corrections that Clinton budgets made on this issue, the draft interim report presents a misleading picture of the views of the Clinton Administration.

[11] Office of Management and Budget, *Fiscal Year 2001 Budget: Analytical Perspectives*, page 346.

National Saving, Social Security, and Individual Accounts

Commission Perspective

The draft interim report argues that "increasing national saving is the only sure way to improve retirement security for current workers while also lessening the burden on future generations."[12]

Analysis

We agree that national saving is an important consideration in Social Security reform. That, however, is one reason why carve-out individual accounts are problematic: Given bipartisan agreement to save the annual Social Security cash-flow surpluses, individual accounts financed out of current Social Security revenue will not increase national saving and may well *reduce* it.

Background

The issue of how generous a Social Security system we can afford comes down to our nation's ability to produce more goods and services *in the future* — for only that future production can be used to provide future benefits. A Social Security burden that looks onerous given a certain projection for the Gross Domestic Product (GDP) will appear much less so with a GDP that is, say, 10 percent larger. So a key question is: How large a GDP will we have in the 2030s, 2040s, and beyond?

The size of our GDP one and two generations down the road depends on many things, but one of them is surely how much we save and invest between now and then. Higher national saving finances additional investment today. It thereby increases the capital that future workers will have to produce goods and services. Higher saving today thus translates into higher GDP tomorrow.

The government *adds to* national saving when it runs a surplus (as at present) and it *subtracts from* national saving when it runs a deficit (as was true for many years). Thus, an important question for any proposed Social Security reform — and for federal budget policy more generally — must be: *What will the reform do to national saving*?

Concern about national saving is why Congress put the Social Security surplus in a "lock-box" in this year's budget resolution. The term "lock-box" has been misused by both supporters and opponents, but under any interpretation, it entails a prohibition against spending the Social Security surplus. Passage of a large tax cut this year that has put a big dent in prospective government surpluses makes the national saving issue more significant than it was just a few months ago. So it is important to ask how introducing individual accounts into Social Security would affect national saving.

[12] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 27.

To focus on a concrete example, consider a proposal to divert two percentage points (about $85 billion per year at present) from the Social Security Trust Fund into private accounts. At the level of pure arithmetic, this transfer would have no net effect on national saving: Government saving would *decline* by about $85 billion per year as payroll tax collections declined, but private saving would *rise* by the same amount as the $85 billion was deposited into private accounts.

This is the whole story *if individuals do not react in any way*, which brings us to the harder issue of likely behavioral responses. If, in fact, people see their new private accounts as raising their prospective retirement incomes — which is what proponents of privatization typically claim — it seems reasonable to suppose that some of them will reduce their other saving somewhat. For this reason, the Congressional Budget Office (CBO) has concluded that overall national saving would decline in response to individual accounts:

> "Compared with current law, the proposal [to create individual accounts] would also most likely reduce national saving: government saving would decline because the [individual account contributions] would reduce the surplus and, in later years, increase the deficit. Although private saving would rise, it would not rise enough to completely offset the loss in revenue. Other saving most likely would fall because [the accounts] would increase workers' resources and would reduce their need to save in other forms for their own retirement."[13]

The key point is that individuals are more likely to reduce their other saving (such as in 401(k) plans and IRAs) in response to a dollar deposited into an individual account than a dollar used to reduce public debt. Diverting a dollar of the Social Security surplus, which would otherwise be used to reduce public debt, into individual accounts thus would likely *reduce* national saving. Such reduced national saving would, in turn, reduce future economic production and make it harder for future workers to support adequate retirement benefits.

[13] Letter to the Honorable Bill Archer regarding Professor Martin Feldstein's proposal to set up personal retirement accounts financed by tax credits, August 4, 1998.

Redistribution under Social Security and Individual Accounts

Commission Perspective

The draft interim report argues that "recent studies show that Social Security provides little, if any, systematic redistribution from rich to poor."[14] The draft report thus argues that, contrary to popular perception, Social Security is not particularly progressive.

Analysis

The benefit formula under Social Security is progressive, meaning that it provides benefits that equal a larger percentage of previous earnings for lower earners than for higher earners. The Social Security system is not as progressive as its benefit formula alone would suggest, however, partly because low earners do not live as long as high earners, on average. Nonetheless, Social Security remains quite progressive: Even on a lifetime basis, it provides relatively more resources to lower earners than to higher earners. And if one includes disability benefits, which accrue disproportionately to low and moderate earners, the progressive effect of Social Security is intensified. Furthermore, and most importantly, most individual account proposals would be *regressive*.

Unfortunately, the commission's presentation on this important issue is biased and incomplete. It ignores recent studies showing that Social Security is becoming *more* progressive over time, it fails to compare Social Security to a likely individual account system, and it presents a misleading picture of Social Security's effects on minorities and women.

Background

The benefit formula under Social Security is progressive: it provides a higher replacement rate (that is, it provides benefits that are higher relative to previous earnings) for lower earners than for higher earners. Consider, for example, workers currently in their 30s. Social Security benefits would replace approximately 56 percent of previous wages for those with steady low earnings, 42 percent of previous wages for average earners, and 28 percent of previous wages for those with the maximum taxable earnings each year.

A few recent studies, cited in the draft interim report, explore a variety of reasons why the Social Security system is less progressive than the benefit formula alone suggests.[15] For example, higher earners tend to live longer than lower earners. Lower earners therefore collect their Social Security benefits, on

[14] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 6.

[15] The studies include Alan Gustman and Thomas Steinmeier, "How Effective is Redistribution under the Social Security Benefit Formula," presented at the Second Annual Joint Conference of the Retirement Research Consortium, May 17-18, 2000; Jeffrey Liebman, "Redistribution in the Current Social Security System," forthcoming in Martin Feldstein and Jeffrey Liebman, eds., *Distributional Aspects of Investment-based Social Security Reform*; and Julia Lynn Coronado, Don Fullerton, and Thomas Glass, "The Progressivity of Social Security," NBER Working Paper 7520, February 2000. These studies often exclude some factors, such as disability benefits and the income taxation of Social Security benefits, that make Social Security as a whole more progressive.

average, for fewer years than higher earners. These life expectancy differences reduce, but do not eliminate, the progressivity of Social Security on a lifetime basis.

An individual account system also would likely be of disproportionate benefit to people with longer life expectancies. This is because most individual account proposals would mandate that balances accumulated in individual accounts be transformed into an annuity upon retirement. Since an annuity provides a payment for as long as the recipient is alive, it pays greater lifetime benefits to those who live longer. (Requiring annuities under individual accounts is necessary to ensure that retirees do not outlive their savings, which is why most individual account plans include such a requirement. Social Security also provides an annuity, but it includes a feature not currently available on private annuities: it fully protects benefits from inflation.) Since an individual account system would favor people who live longer and would include a benefit formula that does *not* favor lower earners, it would be regressive on a lifetime basis.

Another factor that has reduced, but not eliminated, the redistribution that Social Security accomplishes is the spousal benefit. It provides benefits to spouses with little or no work history. Historically, this provision has been of primary benefit to higher-earning couples. Increasingly, however, women are working outside the home and earning Social Security benefits on their own earning records, regardless of their husband's earnings. As a new study by Smith, Toder, and Iams (2001) finds, "recent changes in both lifetime earnings of women and marital histories should make OASI more progressive."[16] The draft interim report fails to mention that Social Security is becoming increasingly progressive over time or to note that the relevant basis for comparing Social Security with individual accounts is Social Security in the future, not Social Security in the past. Essentially, the draft interim report uses studies that make it appear that academic research supports its claims, but omits studies by reputable researchers whose conclusions are not consistent with those claims.

The bottom line is that, even after adjusting for the effects of life expectancy differences and the spousal benefit, Social Security favors low- and moderate-earners. Most individual account proposals, on the other hand, start with a benefit formula that is not progressive, because it does not include a higher replacement rate for lower earners. When one incorporates the fact that low earners receive less money on a lifetime basis from annuities because they have shorter average life expectancies, the overall effect of most individual account proposals would be to penalize low earners relative to higher earners.

Impact on Minorities

On a related issue, the draft interim report implies that Social Security is a "bad deal" for minorities because of their shorter average life expectancies.[17] Such a claim ignores four basic factors, which are either not discussed or discussed only briefly in the draft report:

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[16] Karen Smith, Eric Toder, and Howard Iams, "Lifetime Distributional Effects of Social Security Retirement Benefits," presented at the Third Annual Conference of the Retirement Research Consortium, Washington, May 17-18, 2001. See also Lee Cohen, C. Eugene Steuerle, and Adam Carasso, "Social Security Redistribution by Education, Race, and Income: How Much and Why," presented at the Third Annual Conference of the Retirement Research Consortium, Washington, May 17-18, 2001, who reach the same conclusion.

[17] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 24.

- Lower Earnings. Minorities, on average, have lower earnings than the rest of the population, and therefore benefit from the progressive benefit formula under Social Security. *Indeed, the study cited in the commission report as showing that African-Americans are harmed by Social Security actually finds that both African-Americans and Hispanic-Americans enjoy higher rates of return (largely because of their lower earnings) than white Americans.* According to the study, the average inflation-adjusted rate of return on Social Security retirement and survivor benefits is 1.52 percent per year for whites, 1.64 percent per year for blacks, and 2.46 percent per year for Hispanics.[18]

  The commission's report argues that an African-American receives $21,000 less on a lifetime basis than a white with the same level of earnings and marital status. This example is misleading because it compares an African-American and white American *at the same earnings level*, even though African-Americans tend, on average, to have lower earnings and therefore to benefit from Social Security's progressive benefit formula. In other words, African-Americans have both lower earnings and shorter life expectancies than whites. In this example, the commission document misleadingly ignores the effects of lower earnings for blacks and highlights only the effects of shorter life expectancies.

- Hispanic Life Expectancy. Some minority groups, such as Hispanics, appear to have longer life expectancies than whites. Since Hispanics also have below-average earnings, they enjoy relatively high returns under Social Security. Given their low earnings on average, Hispanics would be disproportionately hurt by the lack of progressivity in individual accounts. Yet the commission report both implies that Social Security is disadvantageous to Hispanics and fails to compare the treatment of Hispanics under individual accounts to their treatment under Social Security.

- Disability. Minorities, on average, have higher rates of disability than the rest of the population and therefore disproportionately benefit from the disability benefits that Social Security provides. For example, Social Security data show that 1.1 percent of black workers aged 50-59 became disabled in 1997, relative to 0.6 percent of all workers.[19] Blacks account for 13 percent of working-age Americans, but 17 percent of disabled worker beneficiaries. Disability insurance is currently integrated in many ways with the retirement benefits provided by Social Security. No individual account advocate has shown how disability insurance could be effectively protected from the

[18] See Jeffrey Liebman, "Redistribution in the Current Social Security System," forthcoming in Martin Feldstein and Jeffrey Liebman, eds., *Distributional Aspects of Investment-based Social Security Reform*, Table 2, Part 2. The difference in the rate of return for retirement and survivor benefits between African-Americans and whites is of marginal statistical significance. African-Americans benefit disproportionately from Social Security disability insurance benefits, however, which are not included in the study. If disability benefits were included, the difference in the rate of return between African-Americans and whites would increase.

[19] Office of Policy, Office of Research, Evaluation, and Statistics, Social Security Administration, "Earnings of Black and Nonblack Workers: Who Died or Became Disabled in 1996 and 1997?" Note No. 2000-01, November 2000.

reductions in Social Security benefits that the shift of revenue from Social Security to individual accounts would require.

- Survivors' Benefits. Social Security provides benefits to children of deceased workers (as well as to other survivors). Black children disproportionately benefit from these benefits; they constitute 15 percent of Americans under age 18 but more than 22 percent of the children receiving Social Security survivor benefits. Survivors' benefits, as well, are currently integrated with the rest of Social Security, and individual account plans have not clarified how such survivors' benefits could be insulated from the reductions in Social Security retirement benefits that would likely accompany a system of individual accounts.

- Benefits for Women. The Commission report's depiction of how women fare under Social Security is similarly biased. The report argues that "failure to restructure Social Security" poses a disproportionate threat to the overall retirement security of women."[20] The report fails to examine, however, the degree to which women — especially stay-at-home mothers and lower earning single mothers — would fare less favorably under a system of individual accounts than under the current system because of special features of Social Security that are highly beneficial to women and that individual account proposals do not duplicate.

[20] President's Commission to Strengthen Social Security, Draft Interim Report Revised July 18, 2001, page 22.

Bequests, Wealth, and Individual Accounts

Commission Perspective

The draft interim report argues that, "Rather than ending with the life of the beneficiary, it [Social Security with individual accounts] can be a means of wealth accumulation and long-range investment, giving families resources they never had before, and widening the circle of Americans fortunate enough to pass on the accumulated results of their investments and hard work."[21]

Analysis

The assertion that individual accounts would provide more protection for heirs than Social Security is misleading on two fronts: First, Social Security provides important benefits to heirs through survivors' benefits. These benefits are superior to the benefits that would be available under some systems of individual accounts, because survivors' benefits are fully protected against inflation and private annuities are not. Second, any system that permits accumulated account balances to be transferred to heirs reduces the funds available to support retirement benefits. Simple arithmetic means that the same funds cannot be used twice.

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

Background

Bequests

Contrary to the assertions of some critics and to the statement in the draft interim report, Social Security transfers significant wealth to relatives of the deceased. In fact, $75 billion — approximately 20 percent of total Social Security benefits — were paid in 1999 to survivors of deceased workers. Spouses of deceased workers qualify for survivor benefits if they are age 60 or older (or age 50 if disabled) or of any age if the spouse is caring for a child. So do former spouses who were married to a worker for ten years or more. Additional survivor benefits are paid to children under age 18 (19 if in high school) or of any age if the child becomes disabled before turning 22. All of these benefits are fully protected against inflation and other financial market risks, a feature unavailable on any individual account. As a result, the argument that Social Security provides no resources to the surviving relatives of an individual who dies is simply wrong.

Furthermore, under most individual account plans, retirees would be required to transform their accumulated account balance into an annuity. (As we show above in the section on redistribution, such a

[21] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 4.

requirement is necessary to avoid people outliving their savings and becoming impoverished in very old age.) Under the most basic annuities, the pension dies with the annuitant. To provide a payment to heirs, given a certain accumulated account balance, requires that a retiree receive a lower monthly annuity payment and have less to live on in old age. The iron laws of finance demand such an outcome since the same dollars can be used for only one purpose. Thus, each dollar that a pensioner can bequeath to heirs means a dollar less to support retirement income, because the pool of funds available to finance retirement benefits is reduced. This iron law holds for all pensions — Social Security, private pensions, and individual accounts.

The tradeoff between payments to heirs and retirement income affects the degree to which income from individual accounts could offset reductions in Social Security benefits. As we explained in the background section above, proponents of individual accounts often argue that the annuity payments from individual accounts would be sufficient to compensate for reductions in traditional Social Security benefits. Such claims are incorrect, as we demonstrated in our Century Foundation report last year (the results of which are highlighted in a box above). Such claims become even less tenable if a portion of the individual account provides payments to heirs rather than being solely devoted to financing retirement income.

For example, the estimates in our Century Foundation analysis assumed that all of the accumulated individual account would be used to finance retirement annuities, with none used for bequests. If we had instead assumed that the individual accounts *did* provide such bequests to heirs, retirement income (Social Security benefits plus income from the individual account) would have to fall by even more than 20 percent for the average young worker, which was our estimate for the reduction required *without* bequests. Individual account proponents often highlight potential payments to heirs in the abstract, but then fail to include the cost of making such payments in estimating the retirement income provided by individual accounts. They essentially count the same dollars twice.

Advocates of individual accounts also claim that they would create a new option for people who die *before* retirement to transfer their individual account balances to heirs. This claim, as well, ignores the fact that the same dollars can only be used once. The contributions to Social Security made by workers who die before retirement age and whose families do not qualify for survivors' benefits now help finance Social Security benefits for retirees. If instead these contributions were used to make payments to heirs, the total pool of funds available for retirement benefits would be reduced. As a result, retirement benefits would have to be reduced (or the revenue coming into the system would have to be increased).

Wealth

The broader issue of whether individual accounts produce "wealth" is intimately related to whether they raise national saving. Fundamentally, financial wealth consists of assets that permit individuals to spend more than they currently earn. Under this definition, Social Security is the largest source of wealth to working-age Americans: It allows them to spend more than they earn in retirement. The value of this wealth is more than $10 trillion.[22]

[22] This figure represents the present value of future benefit rights that workers have already earned.

The only way to increase wealth for today's active workers without burdening future generations is to raise U.S. national saving. Such increased saving could occur through new contributions to individual accounts or through new additions to Social Security reserves. Simply shifting funds from Social Security to individual accounts, however, does nothing to increase national saving or wealth. In fact, as the Congressional Budget Office has noted (see the section on national saving above), it could *reduce* national saving and thereby reduce wealth.

The Rate of Return under Social Security and Individual Accounts

Commission Perspective

President Bush has said that individual accounts would provide much higher rates of return than Social Security can provide. The draft interim report notes that rates of return have been declining under Social Security.[23]

Analysis

The supposed higher rates of return on individual accounts are illusory. Indeed, one member of President Bush's own Social Security commission has said as much. In a recent article she co-authored, Olivia Mitchell wrote: "A popular argument suggests that if Social Security were privatized, everyone could earn higher returns. We show that this is false...the net advantages of privatization and diversification are substantially less than popularly perceived."[24]

The ostensibly higher rates of return under individual accounts vanish after incorporating two key adjustments. The first is an adjustment for the inevitable cost of continuing to pay benefits promised under the current system to current retirees and future retirees who have paid into the system for a number of years. The second is an adjustment to reflect the risks associated with the stock market. *Indeed, if funds in individual accounts and the reserves held by the Social Security Trust Fund were invested in the same assets, the yield on individual accounts would be lower, not higher, than the yield on the Trust Fund.* The reason is simple: Social Security would enjoy much lower administrative costs than could a system of 150 million separate individual accounts. Since administrative costs reduce rates of return, the Trust Fund's lower administrative costs would result in its achieving a higher rate of return (after administrative costs) than a system of individual accounts.

Background

Though intuitively appealing, the rate-of-return argument on behalf of individual accounts is false. To understand why the fallacy arises, one must recognize a key fact: Most of the income flowing into the Social Security Trust Funds — 72.6 percent of it in 2001 — goes out immediately to pay benefits and cover other current expenses. This use of funds for current benefits is necessary because past Congresses authorized larger benefits for retirees in the early years of the Social Security system than their payroll taxes could justify; since the Social Security system was new, those who were retirees during the system's early years had not paid payroll taxes for very many years.

The decision to provide generous benefits in the system's early years to retirees who had paid little in payroll taxes resulted in Social Security being operated largely on a pay-as-you-go basis. The payroll

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[23] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 7.

[24] John Geanakoplos, Olivia Mitchell, and Stephen P. Zeldes, "Social Security Money's Worth," in Olivia S. Mitchell, Robert J. Myers, and Howard Young, *Prospects for Social Security Reform* (University of Pennsylvania Press: Philadelphia, 1999).

taxes of current workers financed the benefits of current retirees. The creation of individual accounts would not undo this history. We still would need to pay benefits promised under the current system. No one — neither supporters of Social Security nor advocates of individual accounts — has suggested that benefits payable to current retirees or those soon to retire should be cut significantly. But if these benefits are maintained, workers must continue to pay taxes to support them *regardless of whether the nation retains Social Security or partially replaces it with individual accounts.*

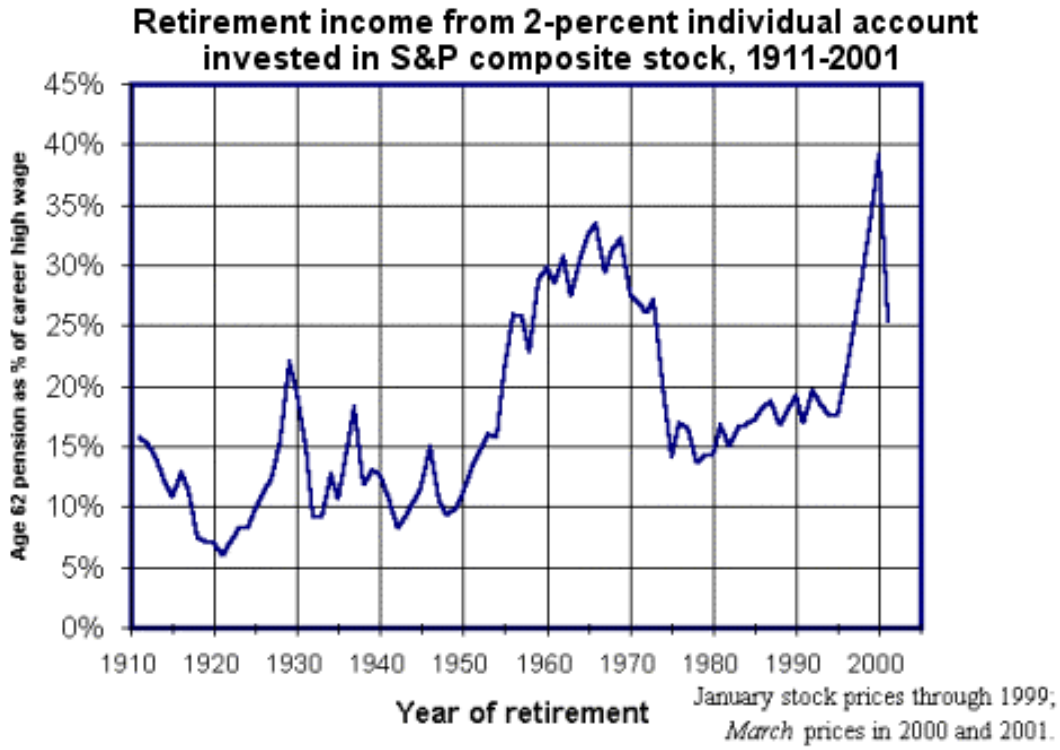
The simple rate-of-return comparison often advanced by supporters of individual accounts ignores this history. It implicitly assumes that 100 percent of Social Security revenue would be available to deposit into individual accounts. Yet 72.6 percent of that revenue is already committed to paying benefits for current retirees and would need to remain devoted to that purpose for many years under individual accounts. The debate about rates of return should therefore concern whether returns on the remaining 27.4 percent of Social Security income would be higher if that income were invested in individual accounts rather than placed in the Social Security Trust Fund.

Advocates of privatization point out that a mixed portfolio (60 percent stocks and 40 percent bonds) has earned an *average* annual return of approximately 5.5 percent (after subtracting inflation and administrative costs). This historical average, however, masks substantial fluctuations in returns during different years and decades. By contrast, Social Security reserves are now invested exclusively in government bonds, which are projected to earn an annual return of roughly 3 percent (after subtracting inflation and administrative costs). This comparison raises two questions: First, can individuals count on receiving returns from private securities that match the historical average returns on such securities? Second, can the returns on Social Security be increased?

On the first question, returns on investments in private securities are far less reliable than returns on Social Security. Consider the retirement income that individual accounts invested in common stocks would have produced for workers in the past. The graph below presents the results for workers who retired in different years but otherwise were identical. Because of the poor stock market performance in the early 1970s, for example, retirees who turned age 62 in 1975 would have received a pension from their individual accounts that was less than half as large (relative to their earnings) than the pension that workers who retired in 1969 would have received. Similarly, the recent collapse of stock prices would have produced sharp disappointments: the retirement income provided by an individual account invested in common stocks would have been roughly one-third smaller for a worker retiring in March 2001 than for a worker retiring in March 2000. Social Security replacement rates also have varied, but the fluctuations have been much smaller and more gradual because Congress has spread the effects of adjusting to unanticipated surpluses or deficits over millions of workers and across generations. No such spreading of the adverse effects of a fall in stock prices is possible with individual accounts.

In addition, while private securities may generate higher average returns than government bonds do, these higher returns can be secured without subjecting individual workers to the risks inherent in individual accounts. Instead of diverting Social Security revenue into private accounts, the revenues not required to pay current Social Security benefits could be invested by private fund managers on behalf of the Social

Security Trust Fund. These fund managers would be instructed to invest in a broadly diversified, passively managed portfolio of private bonds and stocks.



Source: Gary Burtless, The Brookings Institution. The figure assumes the individual account is entirely invested in the stock market.

Such Trust Fund investments would earn higher *net* returns than the average returns on individual accounts, because the administrative costs of managing the investments of the Trust Fund would be far lower than the costs of managing 150 million separate individual accounts, most of which would be quite small. (If contributions to individual accounts were made on a bi-weekly basis, half would be *smaller than* $15. Such accounts would be very expensive to administer, relative to the amounts they would hold.) The average *annual* cost of administering individual accounts would fall in a range of between 0.4 percent and 2.0 percent of funds on deposit, depending on the range of assets among which individuals could choose, the frequency with which individuals were allowed to trade, and the degree to which private fund managers were allowed to advertise.[25] By contrast, the cost of administering investments for a central trust fund would be less than 1/100th of 1 percent a year.[26]

[25] Individual account proposals face a fundamental dilemma: To minimize administrative costs and the need to undertake substantial education of investors, individual account systems must sharply reduce the choices investors have. But such restrictions would likely make individual accounts substantially less attractive to the American public. Designers of individual accounts are thus forced to accept either high administrative costs and the risk that individuals will fail to choose investments wisely, or the unpopularity associated with substantially restricted choices.

[26] *Report of the 1994-1996 Advisory Council on Social Security*, Volume I: Findings and Recommendations (Washington, DC: 1997), page 170.

Although these annual differences in administrative costs may seem small, they cumulate to quite large amounts over a 40-year life of a pension fund. For example, a 1.0 percent fee charged annually on an account over a 40-year career reduces the ending balance of that account by about 25 percent relative to an account on which no fees have been charged.[27] Thus, if a given investment policy would produce $1,000 under Social Security, the same investment policy would produce only about $750 if annual administrative costs equaled 1.0 percent of funds on deposit, which is less than the average cost of today's stock mutual funds. The other $250 would go to cover broker's costs, advertising, other paperwork, and financial company profits. Holding down administrative costs means more money — and a higher rate of return — for pensioners. This is why the Social Security Trust Fund would earn higher rates of return for beneficiaries than a system of individual accounts if both were invested in similar assets.

[27] With a 1.0 percent annual charge on holdings in accounts, a dollar deposited in an individual account in the first year of a 40-year career will be subject to the 1.0 percent fee 40 times, while a dollar deposited in the final year before retirement will be subject to the fee once. On average, dollars in the account will be subject to the 1.0 percent annual charge roughly 20 times, suggesting that approximately 20 percent of the account will be consumed by these charges. The precise figure depends on wage growth and the rate of return, as well as the time profile of contributions and fees over the worker's career. Commission staff documents show the 25 percent figure. See President's Commission to Strengthen Social Security, Background Materials for June 11 meeting, Section 4.F.3.

The Baseline Used to Evaluate Reform Proposals

Commission Perspective

A baseline is intended to reflect what would happen if underlying trends played out without any changes in government policy. The Social Security benefits produced by the current-law benefit structure are projected to exceed available revenue, raising the question of how to define "current benefits" in the baseline. Should the baseline reflect the benefits that would be provided under the benefit structure in current law, as the baselines employed by all other Social Security commissions have done? Or should the baseline reflect the reduced benefits that could be paid if no other steps were taken to close Social Security's long-term financing shortfall?

It remains unclear what baseline the commission will use to evaluate its proposals. The staff background documents prepared for the commission's first meeting suggest that instead of using current-law benefits and current-law revenue as the starting point for changes in the system — and employing a baseline that shows a financing gap, as the other Social Security commissions have done — an alternative baseline should be used that eliminates the financing gap.[28] The leading alternative baseline proposed in the commission staff materials would reduce the level of benefits shown in the baseline to the level that currently legislated Social Security tax revenue could finance. Under this approach, these reduced benefit levels would be the "baseline" against which proposals to alter Social Security would be judged.

The draft interim report does not address the "baseline issue," and figures presented in the report are consistent with the standard baseline concept. (That is, the draft interim report presents figures which show cuts that would eliminate Social Security's long-term deficit as being benefit reductions, rather than assuming such benefit reductions as part of the baseline itself.[29])

Since the staff proposal would represent a substantial shift away from traditional practice and some senior Bush Administration officials have called for such a proposal to be adopted — and it is unclear what baseline the commission ultimately will use for evaluating reform proposals — this section examines the problems associated with the alternative baselines proposed in the commission staff background materials.

[28] President's Commission to Strengthen Social Security, Background Materials for June 11 meeting, Section 1.C.

[29] President's Commission to Strengthen Social Security, Draft Interim Report, Revised July 18, 2001, page 18.

Analysis

A baseline is intended to reflect what would happen without any changes in government policy. The traditional Social Security baseline therefore projects Social Security benefits using the current-law benefit formula and Social Security revenue using the current-law revenue structure. This baseline shows Social Security as having a long-term financing shortfall. This approach is sensible: It embodies the program's statutory features as they now stand and projects what would happen in the future under that program structure. To be sure, projected expenditures exceed projected revenues. That means that Congress must modify benefits, revenues, or the rate of return on the Trust Fund to restore long-term balance. Adopting the alternative "baselines" suggested by the commission staff under which benefits are assumed to be reduced sufficiently to eliminate the shortfall would assume away the system's long-term deficit by implicitly adopting large reductions in benefits, and would do so without debate on this issue or consideration of other approaches to closing the long-term deficit.

If the commission were to adopt the staff's novel approach to the baseline, that would appear to be an attempt to redefine the debate over Social Security by commission fiat, rather than through debate as part of the political process. The benefits of redefining the baseline would be fundamentally political for advocates of individual accounts. Such a change in the baseline would make the reduction in traditional benefits required under carve-out individual account proposals appear smaller and therefore potentially more acceptable.

Under the commission staff's alternative baselines, Social Security no longer would have a 75-year deficit. These baselines would make the deficit disappear, by incorporating major policy changes in the baseline. To call for reform of Social Security by pointing to the 75-year deficit, and then to adopt a baseline that assumes no such deficit exists, is not likely to promote popular understanding of Social Security reform issues.

Background

The Social Security Trustees project that under the current benefit formula, total benefit payments will amount to 15.44 percent of taxable payroll over the next 75 years. They also project that under current-law financing for Social Security, revenues will amount to 13.58 percent of taxable payroll over the next 75 years. Social Security expenditures are therefore expected to exceed Social Security revenues by 1.86 percent of taxable payroll (15.44 minus 13.58). In other words, the shortfall over 75 years is projected to equal 1.86 percent of the wages that will be subject to the Social Security payroll tax over that period. (Another way to think about this imbalance is that a payroll tax increase of 0.93 percent of wages assessed on employees and employers alike would eliminate the projected deficit and enable the Social Security system to pay full benefits over the next 75 years.) The Social Security actuaries have a long and distinguished record in producing these baseline estimates. Previous Social Security commissions and others have used such estimates to evaluate the adjustments needed in the program.

Since the benefits produced by the current-law benefit structure are projected to exceed available revenue, a question arises as to how "current benefits" should be defined in the baseline. Today, Social

Security pays a benefit of roughly $900 to a worker retiring at age 62 with a history of average earnings. If Social Security revenues are not increased, the system will be able to pay the equivalent of $790 (12 percent less), on average, over the next 75 years. The question is whether $900 or $790 should be considered the baseline. (The 12-percent reduction reflects the long-term deficit of 1.86 percent-of-payroll in Social Security as a percentage of the projected benefit costs of 15.44 percent-of-payroll. Since 1.86 is 12 percent of 15.44, the long-term deficit in Social Security could be eliminated by reducing all benefits over the next 75 years by 12 percent.)

In 1983, when the Greenspan commission considered Social Security finances, it took the equivalent of $900 as the starting point. It then made recommendations to bridge about half the gap between $790 and $900 with benefit reductions (phased in over time) and to bridge the other half of the gap with payroll tax increases.

In contrast, the two leading "baselines" suggested in the staff background documents implicitly assume that benefit cuts will be used to eliminate the *entire* difference between the benefit level promised under current law ($900 for the average worker) and the benefit level that could be financed with current revenues ($790). Benefit reductions of this magnitude appear to be a corollary of both the President's stipulations that commission members not raise the payroll tax or diversify the investment of the Trust Fund's assets, and also of the government's inability to devote a portion of projected *non*-Social Security surpluses to Social Security to reduce the financing gap because of the recently enacted tax cut. These constraints appear to be leading the commission staff to suggest that consideration be given to using figures that assume a 12-percent benefit reduction as the starting point for the commission's deliberations.

Such an assumption, however, would *not* be a neutral starting point. To the contrary, it reflects major policy decisions that should be part of what is discussed in the commission's deliberations.

If the commission does set its "baseline" in this manner, it will essentially be proposing to eliminate the 75-year Social Security shortfall solely with Social Security benefit cuts. This issue should be debated, not swept under the rug by being assumed in a new type of baseline that breaks with the standard way of analyzing these issues. The Bush Social Security commission should adopt the same transparent and traditional approach to the baseline that earlier commissions followed — including the Greenspan commission in the early 1980s and the Advisory Commission in the mid-1990s.

In addition, the commission staff's suggested alternatives to the traditional baseline would produce major anomalies. The following are a few examples.

- The President has called for protecting the full Social Security benefits of current and near-retirees, along with survivors and the disabled. Under the commission staff's two leading baseline proposals, such a step would appear as a benefit *increase* rather than as the maintenance of current benefits. Under these alternative baselines, all benefits under the Social Security system would be assumed to be reduced by 12 percent; relative to such a baseline, protecting certain benefits at their current levels would appear to constitute a benefit increase. Using a baseline under which adhering to the President's call to *retain*

parts of the current system is portrayed as a benefit *increase* is likely to confuse — and mislead — the public.

- Under the commission staff's two leading alternative baselines, proposals to roll back parts of the recent tax cut before they take effect and devote the saved revenue to the Social Security Trust Fund to sustain benefits would appear as Social Security benefit increases, rather than as moderating the size of any required benefit reductions. It is more appropriate to view such a policy change as a way to help finance the existing Social Security benefit structure than to portray it as a way to increase Social Security benefits. It distorts the debate to label actions that simply sustain current-law benefit levels as benefit increases, and to label as the "baseline" a policy that cuts benefits promised under current law.

- Under the commission staff's alternative baselines, Social Security would no longer have a 75-year deficit. These baselines make the deficit disappear, by making hidden, yet crucial, policy choices. To call for reform of Social Security by pointing to the 75-year deficit, and then to adopt a baseline that assumes no such deficit exists, is not likely to promote popular understanding of Social Security reform issues.

Such anomalies suggest that the alternative baselines suggested by the commission staff are likely to confuse rather than illuminate the debate. Since the alternative baselines are inconsistent with the practices of previous commissions, and since they are likely to be a source of significant confusion, the most likely rationale for the adoption of such alternative baselines by the commission would be political — to make the reductions in traditional Social Security benefits under a plan that diverted revenue from the Social Security Trust Fund to individual accounts look substantially smaller.