"The Implications of the Tax Bill for Social Security Reform: The Challenges Facing the Bush Social Security Commission"

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Mr. Chairman and Members of the Committee, it is an honor to appear before you this morning to discuss Social Security reform and long-term budgetary pressures. My testimony will focus on the interaction between the recently enacted tax cut and the prospects for Social Security reform.

On May 2, President Bush appointed a commission on Social Security reform, which held its first meeting on June 11 and its second meeting on July 24. The commission faces a daunting challenge: how, in the aftermath of the enactment of the recent tax cut, to finance such accounts.

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 consumed essentially 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. Such an approach, however, would either exacerbate the long-term deficit in Social Security or require deep reductions in traditional Social Security benefits. Neither of those outcomes is likely to be viable politically.

The tax cut thus leaves the commission and policy-makers in general with politically unappealing choices. Policy-makers might be tempted to sidestep these unappealing choices by using budget gimmicks. My testimony this morning explores the dilemma in which policy-makers committed to Social Security reform find themselves following the tax cut, and includes an examination of the types of accounting gimmicks policy-makers could be tempted to consider to finance individual accounts.

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The Long-Term Deficit in Social Security and Individual Accounts

The Social Security Trustees project that under current law, Social Security faces an imbalance over the next 75 years equal to 1.86 percent of taxable payroll, or 12 percent of projected expenditures. 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 is then projected to be exhausted in 2038.

To improve Social Security's financial condition, four basic options exist: increase Social Security tax revenue, reduce Social Security benefits, raise the returns on the Social Security Trust Fund, or transfer funds from the rest of the budget to Social Security. Individual accounts, in and of themselves, do nothing along these four dimensions and therefore do not directly improve Social Security's financial condition. Rather, the typical argument is that the income from the individual accounts would permit reductions in traditional Social Security benefits without causing significant hardship for beneficiaries. The implicit argument behind individual accounts is thus that the long-term deficit within Social Security could be eliminated through traditional benefit reductions, but that the income from individual accounts would provide a replacement for those benefit reductions.

As explained below, however, carve-out individual accounts (financed out of Social Security revenue) would result in substantial declines in expected *total* retirement income, including the income from the individual accounts, relative to the current Social Security benefit formula. The reductions would be so large that financing individual accounts out of current Social Security revenue is unlikely to be politically viable. (It should be noted that with or without individual accounts, a significant reduction in total retirement income would be necessary to restore long-term Social Security solvency in the absence of general revenue transfers. Such transfers are thus a critical component, albeit not the only component, of a sound Social Security reform plan regardless of whether individual accounts are created.) Furthermore, the large tax cut precludes financing add-on accounts without creating deficits outside Social Security and Medicare.

In short, carve-out accounts would involve politically unappealing reductions in traditional Social Security benefits. Add-on accounts might have proven to be more politically attractive, but given the tax cut recently signed into law, they would create large deficits in the non-Social Security budget. The basic problem is that non-Social Security revenue is needed to make a Social Security reform package (whether or not it includes individual accounts) politically viable, but the tax cut undermines such an approach.

Financing Add-on Individual Accounts out of the Non-Social Security Surplus

Add-on accounts would be financed from the non-Social Security budget. In the aftermath of enactment of the new tax, however, financing accounts in this way would cause deficits outside of the Social Security and Medicare Hospital Insurance Trust Funds.

According to estimates from the Congressional Budget Office, the projected surplus over the next 10 years outside of Social Security and Medicare Hospital Insurance amounted to $2.74 trillion prior to enactment of the new tax legislation.[2] Taking into account the new tax law and the other initiatives in the Congressional budget resolution, such as a prescription drug benefit, the remaining surplus outside the Social Security and Medicare Hospital Insurance Trust Funds appears on paper to be about $500 billion between 2002 and 2011.

Between 2002 and 2011, contributions to individual accounts equal to two percent of wages would amount to more than $1 trillion. Such contributions consequently could not be financed from the non-Social Security, non-Medicare part of the budget without creating deficits there.

Moreover, the situation is even less promising than such a simple comparison would suggest, because the official budget forecast embodies several extremely unrealistic assumptions, and as a result, not even $500 billion is likely to be available for individual account contributions. The unrealistic assumptions include:

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- Artificial sunset. The figures above assume that the $1.35 trillion package of tax cuts, as signed by the President, actually will expire on December 31, 2010, and that several other provisions of the law — including a measure providing relief from the Alternative Minimum Tax — will expire between 2004 and 2006. These "sunsets" are not credible. In the absence of an underlying shift in policy, it is unrealistic to assume the wholesale expiration of the tax cuts after 2010 or termination of AMT relief after 2004.

- Expiring tax credits. The figures also assume that the tax credits that are routinely extended a few years at a time (and are always renewed with strong bipartisan support) will *not* be extended and will therefore be ended in the next few years. These "extenders," including the popular research and experimentation tax credit, are certain to continue being renewed.

- Defense spending. The figures assume that funding for defense will be limited to the level assumed in the budget plan that Congress adopted in May. The President has since requested an increase of $18 billion over that level for fiscal year 2002, which translates into an additional $200 billion over ten years if the requested 2002 level is simply maintained in subsequent years, with an adjustment only for inflation. Since the $18 billion request does not include funds for a national missile defense,

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[2] Such projections are highly uncertain, as CBO itself emphasizes. This estimate also is likely to be revised downward later this summer, when CBO issues a new forecast.

the added defense costs over the next ten years could easily be well in excess of $200 billion.

- Non-defense discretionary spending. The figures assume that funding for *non*-defense discretionary programs over the next decade will fall significantly in real per capita terms over the next decade. The Congressional budget plan assumes a spending level for these programs that is $45 billion below what is needed simply to keep pace with inflation over the next ten years, and more than $200 billion below what is needed for these programs to remain constant in real per-capita terms (i.e., for the appropriation levels for these programs to keep up with inflation and changes in the size of the U.S. population). Past experience strongly suggests that the level the budget plan assumes for non-defense appropriations is unrealistic and unattainable. The current bipartisan interest in boosting funding for education, health research, and other areas adds to the likelihood that this level will be surpassed.

After making an adjustment just for the extension of the expiring tax credits (the second item above), the available non-Social Security, non-Medicare surplus vanishes for the years from 2003 to 2006.[3] Yet even this does not reflect likely defense spending increases or realistic levels for non-defense discretionary programs. Nor does it include *any* funds for relief from natural disasters — such as hurricanes, floods, and earthquakes — which have been averaging $5.6 billion a year. Finally, these figures do not reflect the impact of the recent economic slowdown on the budget forecast.

When realistic assumptions are taken into account, there is thus no meaningful surplus over the next 10 years left to transfer to Social Security or individual accounts. The upshot is that the tax cut and the other provisions reflected in the budget resolution prevent add-on individual accounts (or general revenue transfers directly to the Social Security system) without creating a deficit outside the Social Security and Medicare Trust Funds.

Financing Carve-out Individual Accounts out of the Social Security Surplus

An alternative approach would be to create carve-out accounts financed out of existing Social Security revenue. Over the next 10 years, Social Security is expected to run cash-flow surpluses totaling approximately $2.5 trillion. Over the longer term, however, Social Security is expected to run a significant deficit, amounting to about 1.9 percent of taxable payroll over 75 years. The Social Security Trustees project that the Social Security Trust Fund will become insolvent in 2038.

[3] See Richard Kogan, Robert Greenstein, and Joel Friedman, "How Much of the Surplus Remains After the Tax Cut?," Center on Budget and Policy Priorities, June 2001.

President Bush could finance his individual account proposal by diverting part of the projected Social Security cash-flow surpluses into individual accounts. That approach seems most consistent with language he has used to describe his proposal. By itself, however, diverting revenue from Social Security to individual accounts would exacerbate Social Security's long-term financial imbalance because it would reduce the revenue available to the Social Security system (see Table 1). For example, if individual account contributions amounted to two percent of payroll, the Social Security Trust Fund would be exhausted in 2024 rather than in 2038 if no other changes in Social Security were made (i.e., if Social Security benefits were not reduced or payroll taxes raised).

Table 1

Impact of diverting revenue into individual accounts on Social Security solvency

	Current law	Divert two percent of payroll into individual accounts, starting in 2002 (with no other changes)
Payroll taxes less than benefits	2016	2007
Total income (payroll taxes plus interest on Trust Fund) less than benefits	2025	2015
Trust Fund exhaustion date	2038	2024

To *improve* Social Security's long-term financial situation while diverting revenue into individual accounts requires some combination of higher payroll taxes, investing part of the Social Security Trust Fund in higher-yielding assets (such as stocks), transfers to Social Security from the rest of the budget, and reductions in Social Security benefits. The Administration's principles for Social Security reform rule out raising the payroll tax or having a portion of the Trust Fund reserves invested in equities. Furthermore, as already explained, transfers from the non-Social Security surpluses to the Social Security system would cause substantial deficits outside the Social Security and Medicare Hospital Insurance Trust Funds given the tax cut. Consequently, the only remaining choice to prevent Social Security's projected long-term deficit from worsening if funds were diverted from the Trust Fund to individual accounts would be to reduce Social Security benefits.

Henry Aaron, Alan Blinder, Alicia Munnell, and I have examined the size of the benefit reductions that would be needed to restore Social Security solvency while diverting payroll tax revenues equal to two percent of wages into individual accounts starting in 2002.[4] President Bush has promised to protect benefits for current retirees, older workers, survivors, and the disabled. To protect benefits for these people while diverting payroll tax revenue equal to two percent of payroll

[4] Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation, June 2000.

into individual accounts and also eliminating the long-term deficit within Social Security would require reductions in Social Security benefits (relative to the benefits that would be provided under the current-law benefit formula) of more than 40 percent (see box).

Why Benefits Would Have to be Reduced More than 40 Percent

To see why benefit reductions averaging 40 percent or more would be required if revenue equal to 2 percent of payroll were diverted from Social Security into individual accounts, note that the Social Security actuaries project that maintaining current-law benefits would cost an average of 15.4 percent of payroll over the next 75 years. The projected long-term deficit in Social Security equals just under 2 percent of payroll. Diverting two percentage points of payroll into individual accounts thus would raise the long-term deficit to almost 4 percent of payroll. The benefits that the President has said he would protect — benefits for current retirees, near retirees, and the disabled — amount to about 6 percent of payroll. This leaves 9.4 percent (15.4 percent minus 6 percent) available to be reduced. Eliminating a deficit of almost 4 percent of payroll when the available benefits that could be reduced amount to 9.4 percent of payroll requires a reduction in benefits averaging roughly 40 percent (since 4 percent equals about 40 percent of 9.4 percent).

Such an across-the-board reduction 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 total retirement income for older workers, which would not be politically viable, the reductions in Social Security benefits would have to be phased in over an extended period of time. Because less would be saved in early years as a result of this phase-in of the benefit reductions, the reductions for workers who are young today would have to be larger to ensure that Social Security remains solvent over 75 years. Our analysis found that under one plausible approach to 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 now aged 30 or younger, relative to the Social Security benefit levels 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 occur. We estimated that the expected combined retirement income from Social Security and individual accounts for single individuals with average earnings who are 30 years old in 2002 (and who 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 (see Table 2). For one-earner married couples with average earnings who are 30 years old in 2002 and retire at age 65, the expected combined income from Social Security and individual accounts would be 33 percent below the level these couples would get from Social Security under the current benefit structure.

It is worth noting that these figures are based on assumptions that are favorable to individual accounts and are more likely to understate than overstate the benefit cuts that would be required. These assumptions generally are identical to those made by Professor Martin Feldstein, a leading

advocate of individual accounts. These assumptions were used to show that even under assumptions favorable to individual accounts, the required benefit reductions would be substantial.

Table 2

Impact of Two-percent Individual Account Contributions Financed out of Social Security Revenue for a 30-year-old Single Earner with Average Wages	
	2000 inflation-adjusted dollars
Annual Social Security benefit under current-law benefit structure	$15,877
- 54% reduction	-$8,510
+ Individual account retirement income	+$5,305
Total combined benefit	$12,672
Relative to current law	-20%

Source: Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orszag, "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," The Century Foundation, June 2000.

In summary, financing individual accounts out of projected Social Security reserves would involve either a significant deterioration in Social Security's long-term financial health or substantial reductions in Social Security benefits. Either choice would be likely to encounter stiff opposition on Capitol Hill.

This reality is why many analysts believe that serious Social Security reform requires additional funds from outside of Social Security to be politically viable. Nearly every major plan in recent years to restore long-term Social Security solvency, regardless of whether it creates individual accounts, has relied in part on transferring some of the surpluses projected in the non-Social Security budget to the Social Security Trust Fund. For example, President Clinton proposed transfers of non-Social Security surpluses to Social Security. So did the Social Security plan advanced in the last Congress by then-Ways and Means Committee chairman Bill Archer and Social Security subcommittee chairman Clay Shaw. In the aftermath of the tax cut, however, no such funds are available.

Accounting Gimmicks

To avoid these obstacles to financing individual accounts in the aftermath of the tax cut, policy-makers may be tempted to adopt an accounting gimmick. The purpose of the accounting gimmick would be to hide the difficult tradeoffs involved in financing individual accounts. Such gimmicks would disguise, but not remove, the cost of the individual account contributions.

At least three accounting gimmicks could be employed:

- "Double-counting" the Social Security surplus while changing budget accounting rules to mask the effect of this approach on the budget;

- Making "loans" from the rest of the budget to the Social Security Trust Fund and not repaying the loans within the next 75 years; and

- Adopting assumptions (often called "dynamic scoring") under which individual account contributions are said to raise national saving and corporate profits, and amounts equal to the additional corporate tax revenue that is assumed to materialize are transferred to Social Security.

These section explores these possible accounting gimmicks.

Double-Counting and Changing the Budget Accounting Rules

To avoid the appearance of either undermining the long-term health of Social Security or necessitating larger reductions in Social Security benefits than would otherwise be necessary, the commission's individual account proposal could credit the same funds to both Social Security and individual accounts while changing the budget accounting rules to mask the cost that such an approach entails.

Under this approach, the annual Social Security cash-flow surpluses would be credited to the Social Security Trust Fund. Rather than being used to reduce public debt, as under the current rules, these funds would then be used to make contributions into individual accounts. In other words, the same funds would both be credited to Social Security and deposited in individual accounts. Peter Ferrara, a leading advocate of individual accounts, has urged in a recent memorandum addressed "to the conservative movement" that this approach be used, writing: "When the [Social Security] surplus funds are used for personal accounts, the government should again provide government bonds to the Social Security trust funds in return. The account option would then not reduce the Social Security trust funds in any way, or reduce at all the funds available to pay current Social Security benefits."[5]

This use of the same funds both to credit the Social Security trust fund (and thereby enlarge its reserves) and to finance another program — in this case, individual accounts — is sometimes referred to as "double counting." It represents a type of budget accounting that was common until the mid-1990s, but has been eschewed in recent years. A return to this type of budget accounting (which usually entails running deficits outside Social Security and the Medicare Hospital Insurance program) may be necessary for a temporary period if the nation enters a recession or extended period of abnormally slow growth, but a broad consensus has developed among policy-makers against using such budget accounting except in periods when the economy is weak.

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[5] Peter Ferrara, "Increasing Retirement Benefits for Working People," Americans for Tax Reform, May 22, 2001.

To see how such an approach to hiding the costs of individual accounts would work, imagine a dollar of surplus Social Security payroll tax that flows into the Social Security Trust Fund under current law. Since the dollar is not needed to pay Social Security benefits now, the Treasury provides the Social Security Trust Fund with Treasury bonds in exchange for these surplus revenues. Today, the Treasury would then use these funds to pay down the publicly held debt. The reduction in public debt contributes to national saving and also reduces the interest payments the Federal government must pay on the debt in the future. It thus reduces future budget pressures outside Social Security, which makes it somewhat easier for the government in the future to honor its promises to pay Social Security benefits.

Now consider what would happen under the double-counting approach that Mr. Ferrara advocates. A dollar of Social Security payroll tax revenue would flow into the Treasury, and the Treasury would issue a bond to the Social Security Trust Fund in exchange for the surplus Social Security revenue. Under the budget accounting rules that the Congressional Budget Office (CBO) and Office of Management and Budget (OMB) have long used, once the Treasury issues this bond to the Social Security Trust Fund, anything the Treasury does with the revenue (other than paying down debt) is considered an expenditure from the non-Social Security side of the budget. Therefore, if the funds were used to finance individual accounts, that would count as an increase in federal expenditures outside Social Security. Such an increase would result in a return of budget deficits outside Social Security and Medicare Hospital Insurance, since (as explained above) no room exists in the projected surpluses outside Social Security and Medicare to finance individual account contributions.[6]

To avoid showing a deficit outside of Social Security and Medicare, the budget accounting rules could be altered through use of an egregious budget gimmick. The Administration and Congress could seek to mask the resulting deficits in the non-Social Security budget by directing CBO and OMB to reverse their existing budget rules and to fail to count the use of these funds to finance individual accounts as an expenditure.

Such a gimmick would camouflage the cost of individual accounts financed with Social Security revenue. It would mask the cost to the Social Security system by continuing to credit the Trust Fund with the surplus Social Security revenue, while camouflaging the cost to the budget by failing to record the deposits in individual accounts as an expenditure. The costs of the accounts must, however, be a cost to either the Social Security system or the rest of the budget. Using a gimmick to make it appear as though this maneuver entails no cost to either Social Security or the rest of the budget would constitute dishonest budgeting and would not be fiscally responsible.

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[6] Note that despite the rhetoric surrounding Mr. Ferrara's proposal, the outcome is equivalent under current budget scoring rules to simply making contributions to individual accounts out of the non-Social Security budget, thereby creating a deficit outside the Social Security and the Medicare Hospital Insurance Trust Funds.

Loans from the General Fund to the Social Security Trust Fund

A second accounting gimmick would involve loans from the general fund to the Social Security Trust Fund. To see how this would work, assume that $1 in payroll taxes is diverted from the Social Security Trust Fund into individual accounts. All else equal, that would reduce the funds credited to the Trust Fund and cause the Trust Fund to become insolvent at an earlier date. To avoid exhaustion of the Trust Fund earlier than under current law, the general fund would — under this approach — lend funds to the Social Security Trust Fund. Such loans would be repaid in the future, with interest, from the Trust Fund back to the general fund. The Social Security reform plan proposed by then-Representative John Kasich in 1999 employed such a mechanism.

Under current budget rules, loans from the general fund to the Social Security Trust Fund would not be scored as non-Social Security expenditures — because they are loans that will be repaid with interest — and thus would not cause a deficit in the non-Social Security, non-Medicare budget. Such loans, however, also would do nothing to improve Social Security's long-term deficit, since they would have to be repaid with interest. The loan repayments the Trust Fund eventually would have to make would be equal in present value to the loans the Trust Fund earlier received, with the result that there would be no effect on Social Security's long-term imbalance.[7]

Here is where this approach can be turned into a flagrant gimmick. Such loans could be used to reduce the 75-year Social Security deficit (as opposed to the program's permanent deficit) *if the loan repayments are deferred for such a long period of time that they extend beyond the next 75 years*. This is precisely the approach the Kasich plan used; under that plan, the loan repayments would not even begin until 2060 and would be stretched out for many years after 2075. Placing some of the repayment outside the 75-year window has no effect on the *permanent* imbalance within Social Security, but reduces the apparent imbalance over the 75 years traditionally used to measure Social Security's long-term solvency.

This gimmick thus can be used to help finance individual accounts and make such accounts look like a "free lunch." Loans from the general fund to the Social Security Trust Fund could be employed as a multi-trillion dollar budget gimmick to avoid hard choices and make it look as though long-term Social Security solvency could be restored and individual accounts implemented without either reducing Social Security benefits or causing deficits outside Social Security. Once again, a gimmick would be used to conceal the costs associated with individual accounts.

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[7] Loans do, however, allow the Trust Fund to avoid liquidity (as opposed to solvency) problems: They ensure that the Trust Fund does not become negative for a temporary period, as under many proposed plans, such as the one proposed by Martin Feldstein and Andrew Samwick. See Martin Feldstein and Andrew Samwick, "Allocating Payroll Tax Revenue to Personal Retirement Accounts," *Tax* Notes, June 19, 2000, and as NBER Working Paper 7767, http://www.nber.org.

One reason that this gimmick might be possible is that the accounting rules that apply to transactions of this type have not been thoroughly examined. The gimmick relies on inconsistencies in the treatment of loans between the lender (the budget) and the borrower (the Social Security system). In particular, the gimmick relies on the fact that the loan is not counted as an expenditure from the general fund but is counted as income to the Social Security system over the 75-year period. To avoid such a misleading result, one of two changes should be adopted:

- The Social Security Administration could evaluate 75-year solvency on the basis of the *net* financial position of the Social Security Trust Fund (that is, the financial assets of the Trust Fund minus the financial liabilities of the Trust Fund), rather than just on the basis of the financial assets of the Trust Fund without the financial liabilities being taken into account.

- Alternatively, the Social Security Administration could evaluate 75-year solvency on the basis of the gross assets of the Trust Fund (that is, without subtracting any loans the Trust Fund must repay), while the Congressional Budget Office would treat any loan to the Social Security Trust Fund as on-budget expenditure.

Either approach would eliminate the potential for this gimmick to be employed. My preference would be for the first alternative, under which the Social Security actuaries would evaluate solvency on the basis of the net financial position of the Trust Fund and the current budget scoring rules for loans would be maintained. That approach appears the most analytically sound.

Dynamic Scoring and Corporate Tax Revenue

A final possible accounting gimmick involves a form of budget accounting that Martin Feldstein and Andrew Samwick have suggested, but that has been rejected by most budget analysts and by the CBO.[8] Feldstein and Samwick would undertake a form of "dynamic scoring," in which assumptions are made about the macroeconomic effects of Social Security proposals and these assumptions are then reflected in the cost estimates for those proposals. (Using dynamic scoring for tax proposals, for example, entails making assumptions about the impact of proposed tax policy changes on economic growth and on the resulting change in revenues that is assumed to arise from the change in economic growth.) This approach has been rejected by CBO, OMB, and policy-makers of both parties because there is little agreement among economists about the response of the economy to changes in tax and budget policies, which makes this approach particularly susceptible to manipulation.

Despite the lack of support for dynamic scoring among budget experts, Feldstein and Samwick would transfer to the Social Security Trust Fund the extra corporate revenue they assume

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[8] See Martin Feldstein and Andrew Samwick, "Allocating Payroll Tax Revenue to Personal Retirement Accounts," *Tax Notes*, June 19, 2000, and as NBER Working Paper 7767, http://www.nber.org.

would result from creating individual accounts. Corporate income tax collections would be higher, they claim, because a Bush-style individual account plan would boost national saving, investment, and GDP. The amount of additional tax collections they assume over the next 75 years is very large — $3 trillion in present value. In other words, their proposal entails transferring the immediate equivalent of $3 trillion from the rest of the budget to Social Security.

Feldstein and Samwick implicitly argue that these $3 trillion worth of transfers to the Social Security Trust Fund would impose no additional burdens on the rest of the budget, because the transfers would reflect net additional revenue from higher corporate income tax collections. Their key assumption is that individual accounts would raise national saving and that higher national saving would then boost corporate income and therefore corporate tax revenue.

The assumption of an increase in national saving, however, is implausible. First, it rests upon another assumption: that in the absence of individual accounts, the Social Security surpluses will *not* be used to pay down debt — which increases national saving — but instead will be used to finance increases in other government programs, despite pledges by both parties to wall off these surpluses. If the Social Security surplus is walled off, the Feldstein-Samwick argument falls apart (Social Security surpluses would already be committed to national saving by paying down the public debt, so shifting these funds from debt repayment to the financing of individual accounts would not increase national saving). In fact, shifting the Social Security surpluses from debt repayment to individual accounts could *reduce* national saving, since individuals may be more likely to reduce their own saving in response to the establishment of individual accounts in their names than in response to a reduction in the government's debt.

In other words, the Feldstein-Samwick argument — that individual accounts would boost national saving, which then would increase economic activity and boost corporate tax collections to such an extent that the added revenue would effectively pay for the individual account contributions — collapses once the suspect assumption is removed that the Social Security Trust Fund surpluses would otherwise be expended.

Furthermore, the magnitude of the increases in national saving and corporate income tax revenues that Feldstein and Samwick assume is so large as to strain credulity. They assume that individual accounts would result in an increase in corporate income taxes equal to 1.7 percent of projected GDP in 2075; by comparison, the entire corporate income tax today amounts to only 1.9 percent of GDP. They assume corporate tax revenue would *nearly double* as a share of GDP as a consequence of individual accounts.

The dynamic scoring approach is essentially another accounting gimmick, as it is predicated on the dubious assumption that national saving would increase dramatically from the creation of carve-out individual accounts and result in massive increases in corporate tax revenues. If the additional corporate revenue failed to materialize, as would likely be the case, the financing of individual accounts under the Feldstein-Samwick approach would entail either large-scale budget

deficits, or substantial program cuts or tax increases in the rest of the budget, to make up for the $3 trillion being transferred from the rest of the budget to the Social Security Trust Fund.

Conclusion

The size of the recently enacted tax cut requires policy-makers to employ one of two unappealing mechanisms for financing individual accounts:

- The individual accounts could be financed by transferring funds from the non-Social Security budget. Because the projected non-Social Security, non-Medicare surplus has been depleted by the new tax cut legislation and other priorities in the budget resolution, however, this approach entails running deficits outside Social Security and Medicare.

- The individual accounts could be financed by diverting payroll tax revenue from the Social Security Trust Fund. That would either accelerate the date on which the Social Security Trust Fund would become insolvent or require large benefit reductions within the traditional Social Security program.

The only other alternative is some form of accounting gimmick. In essence, the large size of the tax cut requires policy-makers to adopt one, or some combination, of three alternatives for financing individual accounts: A deficit outside Social Security and Medicare Hospital Insurance (or substantial budget cuts or tax increases to avert such deficits), large reductions in traditional Social Security benefits, or an accounting gimmick.

Since all of these approaches are politically problematic, the tax cut considerably weakens the chances that the President's commission will succeed in designing a credible plan to restore long-term Social Security solvency. In a fundamental sense, the tax cut has undermined the opportunity that we had, and could potentially recapture, to use the projected budget surpluses as a substantial down-payment on the longer-term budgetary pressures facing the nation.