

Borrowing from Future Social Security Benefits: The Administration's Proposal for Individual Accounts

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Mr. Chairman, thank you for inviting me to testify before you this morning. On February 2, the Bush Administration released some details about its proposal to replace part of Social Security with individual accounts. Even with these admittedly incomplete details, several points now appear clear:²

- Under the Administration's plan, payroll taxes deposited into an individual account are essentially a loan from the government to the worker. The Administration's proposal is the equivalent of a loan that mortgages future Social Security benefits: Workers opting to divert payroll taxes into an account today would pay back those funds, plus interest, through reductions in Social Security benefits at retirement.³ In other words, just as with a loan, the worker receives cash up front and then owes money back, with interest, later. Someone who borrows money to make an investment benefits if the assets purchased with the borrowed funds grow faster than the debt; the person is worse off if the debt grows faster than the investment. Similarly, under the Administration's plan,

¹ The views expressed here are those of the author alone. This testimony draws upon joint work with Peter Diamond, Jason Furman, William Gale, and Robert Greenstein. For a detailed discussion of the issues involved in payouts from individual accounts, see National Academy of Social Insurance, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy*, 2005.

² The Administration still has not specified many important aspects of the accounts. I have tried to reflect the proposal as I understand it, based on official White House documents and on the memorandum from the Office of the Chief Actuary. In some cases, however, these documents contradict each other. As more details about the proposal become available, some of the specific figures cited in this testimony may be slightly affected, but the fundamental points will not be. For other analyses of the Administration's proposal, see Jason Furman, "New White House Details Show the Proposed Private Accounts Would Worsen Social Security's Finances," Center on Budget and Policy Priorities, February 4, 2004; Jason Furman and Robert Greenstein, "An Overview of Issues Raised by the Administration's Social Security Plan," Center on Budget and Policy Priorities, February 3, 2004; and Jason Furman, "How the Individual Accounts in the President's New Plan Would Work: Plan Would Allow Individuals to Mortgage Half of Their Social Security Benefit," Center on Budget and Policy Priorities, February 4, 2004.

³ Although the system operates like a loan, it is not literally a loan because the transaction does not involve a contract. For some purposes, such as budget scoring, the fact that the transaction does not involve a contract and therefore is not legally a loan may be determinative. For further discussion of the budget scoring issues involved in proposals of this type, see Jason Furman, William G. Gale, and Peter R. Orszag, "Should the Budget Exclude the Cost of Individual Accounts?" *Tax Notes*, January 24, 2005.

workers wind up with higher retirement income if the income from their accounts exceeds the benefit reductions that pay off the loan, and vice versa.

- The accounts not only fail to reduce the Social Security deficit, but will likely increase it. Even an Administration official has acknowledged that the accounts proposed by the President would have a “net neutral effect” on Social Security’s financial condition over the long term. The reality is likely to be even worse, however: The accounts will likely *harm* Social Security’s long-term deficit. The reason is that not all the “loans” from diverted revenue will be repaid in full; in several situations, which I will describe below, subsequent benefit reductions will be insufficient to offset the cost of the diverted revenue plus interest. As a result, even over the “infinite horizon” that the Administration favors, the accounts not only fail to reduce the deficit in Social Security; they make it worse. Over the traditional 75-year horizon used to evaluate Social Security solvency, this conclusion is only strengthened.
- The accounts by themselves entail a significant and sustained increase in public debt. By themselves, the individual accounts would increase public debt by more than \$1 trillion during the first decade they were in effect and by more than \$3.5 trillion during their second decade. The increase in public debt, moreover, would be *permanent*: Even if each individual “loan” were eventually repaid in full, public debt would remain higher than in the absence of the accounts over the long term. The reason is that even if each loan were eventually repaid, some loans will always be outstanding. As a result, the government will never, at any point in time, yet have been paid back for all the revenue diverted into accounts – and therefore public debt will always be higher than without the accounts. The bottom line is that the Administration’s account proposal would raise public debt by more than 30 percent of GDP over the very long term. And even if the account proposal were combined with other measures that (unlike the accounts) would reduce the deficit in Social Security, public debt would remain higher than in the absence of the plan for several decades. Such higher levels of public debt are problematic because they increase the exposure of the government to a collapse in financial market confidence.
- The Administration’s ultimate plan will have to rely on severe benefit reductions to eliminate the Social Security deficit. Since by the Administration’s own admission the accounts do not reduce Social Security’s deficit, and since the Administration is opposed to dedicating additional payroll taxes to the program, the Administration’s plan to eliminate the long-term deficit in Social Security must involve severe reductions in benefits (or introduce some new revenue source for the program). In particular, any plan that closes the deficit, includes the accounts the Administration has already proposed, and fails to dedicate additional revenue to Social Security must involve substantial cuts in traditional benefits *beyond* those required to pay back the loans to workers opting for individual

accounts.⁴ The combined effect would be a stunning decline in the defined benefit component of Social Security over time. For example, if one prominent type of benefit reduction (often referred to as “price indexation”) were combined with the loan repayments necessary under the Administration’s accounts, traditional benefits for a young average earner today could decline drastically – instead of replacing more than a third of the worker’s previous wages, Social Security’s defined benefits would replace well under a tenth.

Building ownership and wealth should not come at the expense of mortgaging future Social Security benefits. Nor should Social Security reform be associated with a significant increase in public debt: such an increase is not necessary to reform Social Security or even to create individual accounts. Furthermore, the accounts in the Administration’s plan by themselves would not increase national savings, and could end up reducing it (if individuals decide to contribute less to their 401(k)s and IRAs because they see other money accumulating in their individual account).⁵

A better approach would shore up the existing Social Security system while raising saving in addition to Social Security. Several common-sense steps could substantially boost saving outside of Social Security.

The loan analogy

Under the Administration’s proposal, the individual account system would involve two components: the individual account assets, which would contain a worker’s deposits and the accumulated earnings on them, and a “liability account.” If a worker chose to participate in the individual account system, 4 percent of payroll taxes (initially up to a limit of \$1,000, with the limit gradually eased over time) would be diverted into the account, accumulate during the worker’s career, and be available to the worker upon retirement.⁶ Since the revenue diverted to this account would reduce the financing available to the traditional Social Security system, a “liability account” would also be

⁴ Such a plan would entail two types of benefit reductions: those that would apply only to workers opting for the accounts, which would be intended to repay the loan to the worker, and benefit reductions that would likely apply to all future workers, regardless of whether they opted for an account, which would be intended to eliminate the long-term deficit in Social Security.

⁵ Specifically, if individuals understand that the individual accounts are equivalent to a loan, they may not reduce their other savings. But if they do not understand the nature of the offsetting benefit reduction, then they may mistakenly consider the individual account an asset and reduce other asset accumulation accordingly.

⁶ The limit would increase by \$100 above wage inflation, at least through 2015. The Office of the Chief Actuary, in its memorandum on the proposal, indicated that the parameters of the system past 2015 had not been specified. It is noteworthy, however, that the White House Fact Sheet indicates that: “Under the President’s plan, personal retirement accounts would start gradually. Yearly contribution limits would be raised over time, eventually permitting all workers to set aside 4 percentage points of their payroll taxes in their accounts.” Given this statement, the analysis in this testimony assumes that the threshold would continue to increase more rapidly than wages until all workers could contribute 4 percent of taxable earnings. None of the qualitative conclusions are affected by this specific assumption.

created. This liability account would track the amounts diverted, and accumulate them at a 3 percent real interest rate. The liability account would determine the debt owed back to Social Security at retirement because of the diverted funds.

Upon retirement, the worker's debt to the Social Security system would be repaid by reducing his or her traditional Social Security benefits – that is, the monthly check paid to a retiree. Specifically, the monthly benefit reduction would be computed so that the present value of the reduction would equal the accumulated balance in the liability account. In other words, the reduction in monthly benefits would be just enough, in expected present value, to pay off the accumulated debt to the Social Security system.

This system is quite similar to a loan: As under a loan, the worker receives cash up-front and can invest the money. The worker pays back the borrowed funds, with interest, later. The specific form of the repayment, through a reduction in traditional Social Security benefits, does not alter the underlying nature of the transaction.⁷

To take a specific example, consider a medium-earning worker aged 21 at the beginning of 2011 who elects to participate in the accounts. In inflation-adjusted dollars, the worker would divert about \$500 in payroll taxes into his or her account in 2011, about \$1,000 in 2015, about \$1,500 in 2020, and so on. Those funds would build, along with the investment returns on them, and be available to the worker upon retirement. This worker would also, however, incur a debt to Social Security that would accumulate to more than \$150,000 by the end of 2054, when the worker would be 65.⁸ Repayment of the \$150,000 debt to Social Security would consume roughly half of the worker's retirement benefit under the current benefit formula.⁹

If the assets in the worker's account upon retirement exceed \$150,000, the worker would experience a net increase in retirement income, and vice versa, compared to not participating in the account.¹⁰ Thus the worker's retirement income, on net, increases if

⁷ In effect, the individual accounts proposed by the Administration represent a "Social Security line of credit." Workers drawing upon that line of credit receive payroll revenue in their individual account today, but must pay back the funds at retirement.

⁸ Since the worker was 21 at the beginning of 2011, he or she would turn 22 during 2011. The worker would therefore turn 65 during 2054.

⁹ Note that the worker would be diverting less than one-third of the Social Security payroll tax into the account, but the benefit reduction would total roughly one-half of the benefit under the current benefit formula. The reason is that the loan is correctly charging the *marginal* return on funds within the Social Security system, not the *average* return.

¹⁰ The outcome is identical to the worker borrowing from future Social Security benefits at a 3 percent real interest rate. The worker benefits only if the return to the assets purchased with the borrowed funds exceeds 3 percentage points above inflation. As emphasized in the text, because of administrative costs, the worker would have to earn *more* than 3 percentage points above inflation on the underlying investments in order to break even; the net return above inflation and *after* administrative costs must be 3 percent per year to break even.

the account yields 3 percentage points per year above administrative costs and inflation. The worker's retirement income declines if the account yields less than that.

Note that because of administrative costs, it is impossible for the worker to break even while holding government bonds *and* for the government to be held harmless on the transaction. The reason is that one party or the other must bear the administrative costs of the investment. Under the Administration's assumptions, for example, the real interest rate on government bonds is 3 percent per year. Under that assumption, the system would hold the government harmless as long as the worker reached retirement and paid back the loan (the government would be held harmless since the loan carries the same real interest rate as the projected government borrowing rate). The worker, however, would be worse off if she opted for an account and held government bonds in it. Such an account would have a *net* real yield of 2.7 percent per year (the 3 percent real return on government bonds minus the assumed 0.3 percent per year in administrative costs), leaving the worker with a net reduction in retirement income. The worker's account in this case would grow to only about \$142,000, or almost \$10,000 less than the worker's debt of more than \$150,000 back to Social Security.

Although the loan analogy is insightful in understanding the basic effects of the proposal, there are some important distinctions between a conventional loan and the proposed system. For example, under the Administration's proposal, workers must make a one-time decision to participate in the accounts; after that initial decision, they are required to continue diverting revenue over the rest of their careers.¹¹ (The ability to invest the additional borrowing in Treasury bonds does not necessarily insulate the worker from the effects of the borrowing, given administrative costs and the possibility that the *realized* interest rate on government bonds may in the future diverge from the interest rate on the "loan.") Conventional loans do not typically require the borrower to continue borrowing over time. In addition, the proposed accounts carry restrictions that are not typical of conventional loans: The Social Security loan can only be used for purchasing assets such as stocks held until retirement, and can only be repaid in a specific form (through a reduction in future Social Security benefits).¹² Finally, unlike a conventional loan, this transaction would presumably not involve a contract.¹³ Despite

¹¹ As the White House Fact Sheet put it, "At any time, a worker could "opt in" by making a *one-time* election to put a portion of his or her payroll taxes into a personal retirement account. Workers would have the flexibility to choose from several different low-cost, broad-based investment funds and would have the opportunity to adjust investment allocations periodically, but would not be allowed to move back and forth between personal retirement accounts and the traditional system." See <http://www.whitehouse.gov/infocus/social-security/200501/socialsecurity3.pdf>.

¹² It is unclear whether these restrictions would be sustainable. Most workers currently enjoy some form of access to the balances in their 401(k) accounts prior to retirement. A critical question regarding the Administration's proposal is whether Congress would sustain the prohibition on pre-retirement access even if it were initially adopted. Workers will likely argue that they should indeed have earlier access. At the beginning, such an argument may be made only in hardship cases – such as a terminal disease. Over time, this might evolve into withdrawals for education or first-time home purchases, or into an ability to borrow against an account. Such pre-retirement liberalization would then severely undercut the role of Social Security as financing retirement.

these important distinctions, the loan analogy is useful in evaluating the impact of the proposal.

Accounts do not improve solvency and likely harm it

The loans to workers opting for the accounts carry a 3 percent real interest rate. This rate is equal to the expected real interest rate on government bonds projected by the Social Security trustees in their intermediate cost assumptions. Since the interest rate on the loans is equal to the interest rate that the Social Security system is assumed to earn on its own funds, the system is held harmless on each individual loan, under the trustees' assumptions, as long as the loans are repaid in full. This is why a senior Administration official was quoted on February 2 as saying, "So in a long-term sense, the personal accounts would have a net neutral effect on the fiscal situation of the Social Security and on the federal government." A reporter then asked: "And am I right in assuming that in the way you describe this, because it's a wash in terms of the net effect on Social Security from the accounts by themselves, that it would be fair to describe this as having -- the personal accounts by themselves as having no effect whatsoever on the solvency issue?" The senior Administration official replied: "That's a fair inference."¹⁴

Two crucial points are worth noting about this statement. First, even the Administration now acknowledges that the accounts do *nothing* to reduce the long-term deficit in Social Security. In other words, according to the Administration itself, individual accounts are simply a non-answer to the question of how the deficit in Social Security will be addressed.

Second, the statement by the Administration official is likely to be incorrect: The accounts are likely to harm Social Security's solvency. The reason is simply that there are several likely situations in which the loan repayment back to Social Security (through reduced Social Security benefits) would be insufficient to offset the cost of the diverted revenue. Only if repayment is always made in full will the Administration official's statement prove to be correct. If repayment is incomplete in some circumstances, the accounts not only fail to reduce the Social Security deficit, they actually widen it.¹⁵

Several likely scenarios suggest that at least some of the loans will *not* be repaid in full, and therefore the accounts will *harm* the system's long-term finances:

- Pre-retirement deaths. If a worker dies before retirement without a living spouse, the amount in the individual asset account may be distributed to heirs, but the

¹³ As noted in a footnote above, this distinction may be determinative for the purposes of budget scoring.

¹⁴ Transcript of briefing as posted on Washington Post website: <http://www.washingtonpost.com/ac2/wp-dyn/A59045-2005Feb2?language=printer>.

¹⁵ In theory, one could construct the system so that those actually repaying the loans overpaid, in order to compensate for the losses from those who underpaid. But this would impose even greater costs, beyond the administrative cost issue noted in the text, on workers who elected the accounts and then held bonds in them until retirement.

amount in the individual liability account could be extinguished. This is how the system worked under the proposals put forward by the President's Commission to Strengthen Social Security in 2001; the Administration has apparently not clarified whether the same approach would be adopted now. Under this approach, some loans are not paid off – and the system is thus made financially worse off. The effect may be significant, since roughly one-seventh of workers die before retirement. (The alternative is to have the debt inherited along with the account. In that case, the Administration should clarify that the pre-retirement bequests facilitated by the accounts may be a decidedly mixed blessing: the heirs will inherit both an account and a debt.)

- Backsliding on loan repayments. The benefit reductions necessary to pay off the “loans” from Social Security -- especially if combined with additional benefit reductions to improve solvency -- may be so large that they could prove politically untenable over time. For example, retirees may pressure the government to reduce the loan repayments during periods of weak stock market performance. If such pressures were accommodated and full loan repayments not enforced, the actuarial effect of the accounts could be negative over an infinite horizon.
- Traditional benefits insufficient to finance loan repayment. Even without political pressure to reduce loan repayments, some repayments may be curtailed simply because the traditional defined benefit component of Social Security is too small to pay back the loan in full. In other words, for some workers, the required benefit reductions may exceed the size of the traditional defined benefit part of Social Security that is supposed to provide the repayment financing.¹⁶ In such a situation, the loan would apparently not be repaid in full; in other words, workers would apparently not be forced to repay debts back to Social Security that exceed their traditional benefits. An extreme version of this could arise for workers with less than 10 years of covered earnings, who do not even qualify for Social Security retirement benefits. Such workers would have no traditional benefit against which to apply the loan repayment. If someone working for, say, 5 years were allowed to keep his or her account, the loan may never be repaid, since the worker would not have any traditional benefits with which to repay it. Again, the net result from these types of situations would be that the accounts harm Social Security solvency over the long term.
- Interest rate on Trust Fund more than 3 percentage points above inflation. The interest rate on the loan to workers is apparently specified as 3 percentage points above inflation. That holds the Social Security system harmless on each individual loan, assuming each is repaid in full, as long as the interest rate actually

¹⁶ The example provided in the text above suggested that a medium-earner's loan repayments back to Social Security could represent about half of the benefit under the current benefit formula. For higher earners, the pay-back on the loan would be an even higher share of benefits under the current benefit formula. Compared to the reduced benefits that would exist under the Administration's approach to restoring solvency in Social Security, furthermore, the loan repayments would be even larger.

turns out to be 3 percentage points above inflation. But if real interest rates turn out to be higher than 3 percent, the system would not be compensated sufficiently for the diverted funds, and the accounts would widen the Social Security deficit. It is therefore noteworthy that the Congressional Budget Office assumes a long-term real interest rate on government bonds of 3.3 percent.¹⁷ In other words, under CBO assumptions, the Administration's proposal (with a 3 percent real rate charged on the loans to workers) would *harm* solvency even over an infinite horizon. If real interest rates on government bonds turn out to be lower than the 3 percent rate applied to the loans, the opposite would be true.

These effects mean that even over the problematic infinite horizon preferred by the Administration, the accounts may harm solvency. That conclusion is only strengthened over the 75-year horizon traditionally used to evaluate Social Security solvency. Over that 75-year horizon, the accounts unambiguously widen the deficit even if all loans are ultimately repaid in full. (The reason is that some loans issued over the next 75 years will not have been repaid by the end of the 75th year.)

Accounts entail a significant increase in public debt

According to a memorandum from the Office of the Chief Actuary, the Administration's accounts would raise debt held by the public by \$743 billion as of the end of Fiscal Year 2015.¹⁸ The increase in debt, moreover, would not subside thereafter: If the accounts were continued past 2015, they would raise debt by more than \$3.5 trillion by 2025.¹⁹ Over the first ten years that they were in existence (2009-2018), the accounts would raise debt by more than \$1 trillion; during their second decade (2019-2028), they would raise debt by more than \$3.5 trillion.²⁰ (There has been some confusion over \$743 billion figure and the more than \$1 trillion figure. The \$743 billion figure applies to the *next* ten years. The more than \$1 trillion figure applies to the *first* ten years the accounts would be in existence, from 2009 through 2018.)

The loan analogy helps to explain this increase in debt, and it also provides insight into a surprising result: The debt increase would be *permanent*. To finance a loan to a worker (provided in the form of revenue deposited into an individual account) under the Administration's proposal, the government borrows funds. If the worker repays the

¹⁷ Congressional Budget Office, "Updated Long-Term Projections for Social Security," January 2005, Table W-5, http://www.cbo.gov/Spreadsheet/6064_Data.xls.

¹⁸ "Preliminary Estimated Financial Effects of a Proposal to Phase in Personal Accounts – INFORMATION," Memorandum from Stephen C. Goss to Charles P. Blahous, February 3, 2005.

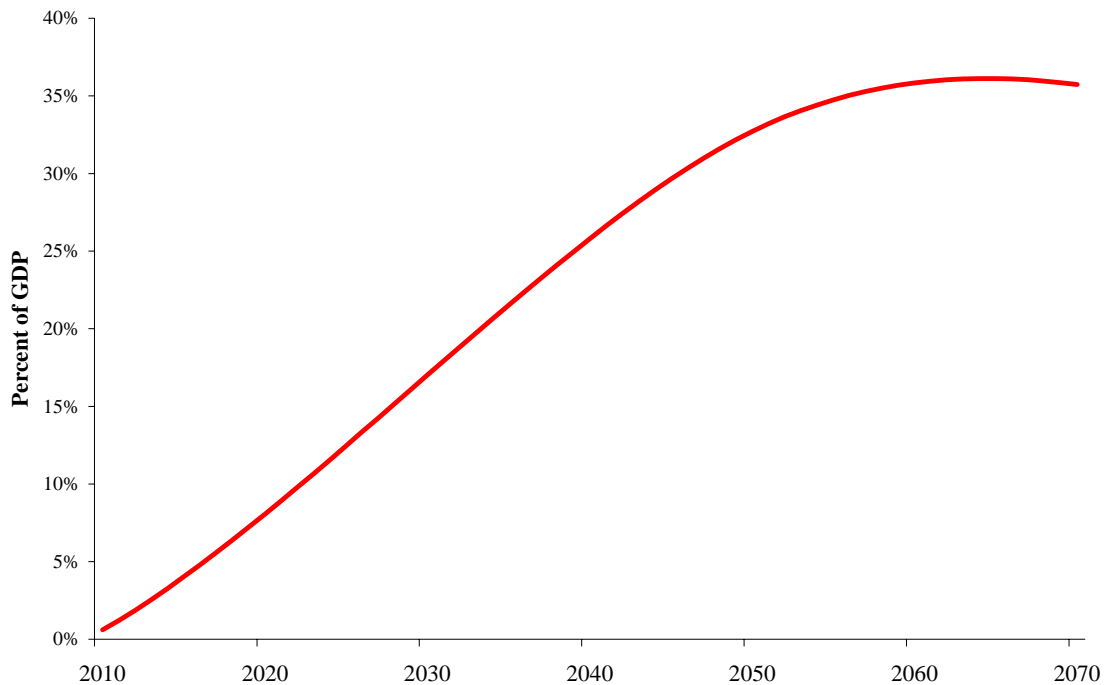
¹⁹ These figures, like the ones in the memo from the Office of the Chief Actuary, assume two-thirds participation in the accounts.

²⁰ Such increases in debt would occur even if the maximum account size were capped at its (wage-adjusted) 2015 level, rather than continuing to be increased more rapidly than wages after 2015 to ensure the White House goal that all workers could eventually contribute 4 percent of payroll to the accounts.

loan, the additional government debt on that transaction is extinguished, so public debt returns to the same level as if that worker had not opted for an account. But note that at any point in time, *even if all loans were eventually repaid*, some loans would always be outstanding. As a result, public debt at any point in time would forever remain higher with the accounts than without them.

Figure 1 illustrates the impact of the Administration’s accounts on debt held by the public. Three aspects of the figure are noteworthy. First, debt increases sharply as a share of Gross Domestic Product (GDP) for roughly five to six decades. Second, the higher level of debt is perpetuated, rather than eliminated, in the long term. Finally, the additional, ongoing higher level of debt in the long term is substantial – the *increase* in debt outstanding of more than 30 percent of GDP is only somewhat smaller than today’s *level* of publicly held debt relative to GDP (38 percent).

Figure 1: Increase in debt held by the public due to Administration’s accounts



Even if the accounts were combined with proposals to eliminate the underlying deficit in Social Security, the increase in debt is likely to be extended and substantial. For example, the leading proposal from the President’s Commission to Strengthen Social Security in 2001 would have changed the determination of individual benefits to incorporate what is commonly -- but somewhat misleadingly -- referred to as “price indexing.”²¹ The change may sound innocuous, but as explained below, it would

²¹ This approach has also been employed in legislation introduced by Senator Lindsey Graham. As noted below, it is more accurately called “real wage growth negating” than “price indexing,” since it removes the

dramatically reduce benefits over time. For the immediate purpose, note that price indexation is sufficient by itself to more than eliminate the long-term deficit in Social Security. Yet even if the accounts proposed by the Administration were combined with this price indexing proposal, debt held by the public would remain higher than in the absence of the combined proposal for roughly five decades.

Some advocates of the Administration's plan argue that the debt shown in Figure 1 merely creates "explicit debt" in exchange for "implicit debt" that the government has already incurred (in the form of future Social Security benefits). From this perspective, advocates argue that the loan transactions merely trade more explicit debt for a reduction in implicit debt (since the loan repayments will reduce future Social Security benefits). The argument is then put forward that these two types of debt -- "implicit debt" and "explicit debt" -- are essentially the same, so that converting one into the other does not represent an increase in federal liabilities and should not raise concerns.

This argument is, however, flawed. The two types of debt are *not* equivalent. The explicit debt that the government would incur as a result of the Administration's proposal for individual accounts would have to be purchased by creditors in financial markets. When the additional debt matured, it would have to be paid off or rolled over. By contrast, the implicit debt associated with future Social Security benefit promises does *not* have to be financed in financial markets now. A government with a large explicit debt thus has less room for maneuver and is more vulnerable to a lessening of confidence on the part of the financial markets than a government with a large implicit debt. Converting implicit debt into explicit debt is thus problematic.

Substantial benefit reductions necessary to eliminate long-term deficit

Since the accounts do not reduce Social Security's deficit (and may expand it), and since the Administration appears to be opposed to dedicating additional payroll tax revenue to the program, the Administration's approach to eliminating the long-term deficit in Social Security must involve some new source of revenue dedicated to the program or rely on severe reductions in benefits *beyond* the loan repayments linked to the accounts. In other words, any plan from the Administration that closes the deficit, includes the accounts it has already proposed, and fails to dedicate additional revenue to Social Security must entail two types of benefit reductions. The first type of benefit reductions would repay the loans to workers opting for the accounts. The second type would be intended to eliminate the long-term deficit in Social Security. The combined effect of these two types of benefit reductions would be a stunning decline in the defined benefit component of Social Security over time.

To examine the impact of relying solely on benefit reductions to eliminate the underlying deficit in Social Security, consider the proposal from Model 2 of the President's Commission in 2001. This proposal would have changed the determination

impact of real wage growth on benefit levels, rather than incorporating a price index directly into the benefit formula.

of individual benefits to incorporate “price indexing,” instead of the wage indexing that is currently used to determine initial benefits. Had this “price indexing” rule been fully in effect by 1983, at the time of the last major reform to Social Security, benefits for newly eligible retirees and disabled workers now would be almost 20 percent lower and continuing to decline relative to current law. These benefit reductions would apply regardless of whether a worker elected to participate in the individual accounts.

Under current law, benefits for new retirees roughly keep pace with wage growth.²² Successive generations of retirees thus receive higher benefits because they had higher earnings -- and paid higher payroll taxes -- during their careers. This feature of the Social Security system makes sense, since a goal of Social Security is to ensure that a worker’s income does not drop too precipitously when the worker retires and ceases to have earnings. A focus on how much of previous earnings are replaced by benefits (which is called the “replacement rate”) recognizes the real-world phenomenon by which families, having become accustomed to a given level of consumption, experience difficult adjustment problems with substantial declines in income during retirement.

Under what is called price indexing, by contrast, initial benefit levels upon retirement would increasingly lag behind wage growth. In particular, real benefit levels would be constant over time, rather than increasing in line with real wages. Since real wage growth is positive on average, the change would reduce initial benefit levels and the size of the reduction would increase over time.²³

Under this proposal, if average real wages were ten percent higher after ten years, the roughly ten percent benefit growth to keep pace with this wage growth would simply be removed. The provision thus is more accurately described as “real wage growth negating” than as “price indexing,” since it simply cancels the benefit increases from real wage growth.²⁴

²² Initial retirement benefits are based on a worker’s average indexed monthly earnings. Average indexed monthly earnings, in turn, are determined by taking earnings in previous years and scaling them up by subsequent national average wage growth. The wage indexing occurs through the year in which a worker turns 60, with later wages used on a nominal basis (unindexed). The initial benefit level is thus indexed to wage growth through age 60. After initial benefit determination, benefit increases are indexed to price growth. Price indexing of benefits begins after the year in which a worker turns 62. Thus there is a gap with no indexing to either wages or prices, which should be corrected -- and could be addressed on a revenue-neutral basis if desired. The formula relating full benefits (the so-called Primary Insurance Amount) to earnings is also indexed to average earnings. In 2005, the Primary Insurance Amount is equal to 90 percent of the first \$627 of AIME; 32 percent of AIME over \$627 and through \$3,779; and 15 percent of AIME over \$3,779. The “bend points” at which the 90, 32, and 15 percent factors apply are indexed to wage growth.

²³ The 2004 Trustees Report projects long-run growth of prices of 3.0 percent per year and long-run growth of taxable wages of 4.1 percent per year, resulting in a growth of real wages of 1.1 percent per year. But real wage growth may turn out to be larger or smaller than this amount.

²⁴ More precisely, the proposal would multiply the 90 percent, 32 percent and 15 percent factors used to compute the Primary Insurance Amount by the ratio of cumulative price growth to cumulative wage growth

Several commentators have underscored the troubling consequences that would result from “price indexing.” Edward Gramlich, a leading economist who chaired the Advisory Commission on Social Security in the mid-1990s and who is now a governor of the Federal Reserve System, has been quoted as saying that if this methodology had been adopted when Social Security was created, [retirees] “would be living today at 1940 living standards.”²⁵ An earlier analysis of the proposal underscored that: “This is like saying retirees who could afford indoor plumbing when they were working should, in retirement, not be able to afford indoor plumbing because their parents' generation could not afford it.”²⁶ Even some leading proponents of the Administration’s broad approach have acknowledged this point. For example, John Goodman, president of the National Center for Policy Analysis, recently commented about the price-indexing proposal: “What people are forgetting is why the system is there in the first place. The reason is that people don’t want to reach retirement age and have their standard of living cut in half.”²⁷

Two implications of reducing benefits to cancel out real wage growth are immediately obvious. First, the longer the “price indexing” provision stays in effect, the larger the benefit cuts, assuming ongoing real wage gains. Second, the more rapid real wage growth, the larger the benefit cuts.²⁸

The bottom line is that under “price indexing,” the role of the Social Security system in allowing the elderly to maintain their standard of living after retirement would decline sharply over time.

Consider the effect of the price indexing proposal combined with the loan repayment for workers opting for the accounts put forward by the Administration. Specifically, as above, consider a medium earner who is 21 in 2011, and assume the worker claims benefits at age 65 in 2054. Given the economic assumptions used by the

between the start date and the year in which a worker becomes entitled to claim benefits. It is thus important to note that wage indexing would still be part of the determination of benefits.

²⁵ Greg Ip, “Social Security: Five Burning Questions,” Wall Street Journal Online, December 19, 2004.

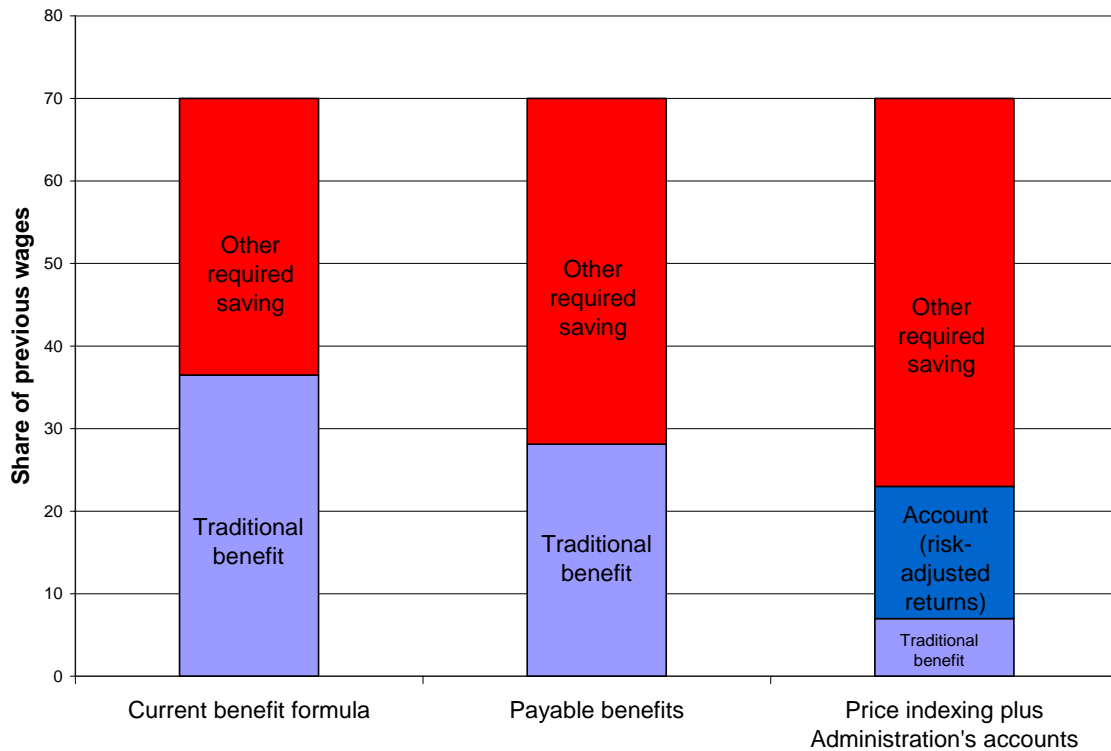
²⁶ “Price-Indexing the Social Security Benefit Formula Is a Substantial Benefit Cut,” prepared by the minority staff of the Social Security Subcommittee, House Committee on Ways and Means, November 30, 2001.

²⁷ Cited in Edmund L. Andrews, “Most G.O.P. Plans to Remake Social Security Involve Deep Cuts to Tomorrow’s Retirees,” *New York Times*, December 13, 2004.

²⁸ This second implication may not be widely understood: The proposal reduces benefits *more* if real wage growth is more rapid than expected. Yet if real wage growth is more rapid, the actuarial deficit over 75 years in the absence of this provision would be smaller, not larger. The use of real wage negating is thus even more troubling than simply reducing benefits based on *expected* real wage growth today. The larger actual real wage growth turns out to be, the smaller the need for benefit reductions -- but the larger those reductions actually are under the real wage negating approach. In other words, the approach introduces variation in benefit reductions relative to scheduled benefits that are larger the less the financial need of Social Security for such reductions.

Congressional Budget Office, price indexing would first reduce this worker’s retirement benefit by more than 35 percent.²⁹ Then the loan repayment for the revenue diverted into the worker’s account would consume about half of the benefit provided by the current benefit formula. As a result, the worker would have a traditional benefit equal to less than one-fifth of the benefit provided by the current benefit formula.

Figure 2: Initial replacement rates at retirement for medium-earning worker claiming benefits at age 65 in 2054



To be sure, the worker would also have an individual account. But the Congressional Budget Office has correctly emphasized that the projected income from such accounts must be adjusted for its riskiness. With the type of risk adjustment adopted by the Congressional Budget Office, the income from the individual account would make up about half of the initial benefit under the current formula.³⁰ The net result would leave the worker with total combined benefits that were roughly 35 percent lower than under the current benefit formula.

²⁹ The figure assumes that price indexing applies to workers who are 54 years old and younger in 2005.

³⁰ The risk adjustment implemented by the Congressional Budget Office is consistent with the approach adopted by the Administration in evaluating stock investments by the National Railroad Retirement Investment Trust. As the *Analytical Perspectives* of the Administration’s Fiscal Year 2006 budget notes (page 421), “Economic theory suggests...that the difference between the expected return of a risky liquid asset and the Treasury rate is equal to the cost of the asset’s additional risk as priced by the market.”

Perhaps more surprisingly, the reduction in benefits even including the account income is roughly twice as large as would be required if benefits in 2054 were simply reduced to match incoming payroll revenue in that year. This level of “payable benefits” is about 20 percent *higher* than the income from the account plus the remaining traditional benefit after price indexing and the loan repayment, under the type of assumptions used by the Congressional Budget Office.

Figure 2 illustrates these effects in terms of the replacement rate at retirement in 2054. Financial planners suggest that a comfortable retirement requires income during retirement equal to about 70 percent of pre-retirement earnings. The current benefit formula would provide about half the necessary amount, requiring the worker to save enough in addition to Social Security to replace roughly 35 percent of pre-retirement earnings. If benefits were reduced to match incoming payroll revenue in 2054, traditional benefits would replace a little under 30 percent of pre-retirement wages, requiring the worker to save a little more than 40 percent of previous earnings.³¹ If the Administration’s accounts were combined with price indexing, however, the traditional benefit after both price indexation and the loan repayment were applied would replace less than 10 percent of previous wages. The income from the individual account would replace a little under 20 percent of previous wages. The net result would be that the worker would have to save substantially more in addition to Social Security; such savings would have to be enough to replace almost half of pre-retirement earnings.

Figure 2 shows that combining price indexing with the loan repayments on individual accounts would cause the traditional benefit to wither on the vine over time.

Conclusion

Individual accounts that mortgage future Social Security benefits raise a number of troubling questions, as this testimony has highlighted. A better approach involves raising saving above and beyond Social Security. As illustrated in Figure 2, individual accounts -- in the form of the 401(k)s and IRAs -- have a critical role to play in filling the hole between the foundation provided by Social Security and a comfortable retirement. Many Americans, however, have not accumulated enough financial assets on top of Social Security. Half of households on the verge of retirement have only \$10,000 or less in a 401(k) or IRA. Yet we now know what works to get people to save in 401(k)s and IRAs, and we're not doing it.

Individual accounts can and should be strengthened outside Social Security, where they belong. Social Security itself can then be shored up through a combination of

³¹ The CBO assumptions show a cost rate in 2054 of 6.39 percent of GDP and an income rate of 4.95 percent of GDP. A benefit reduction of 23 percent ($1 - 4.95/6.39$) would thus reduce cost to income. A reduction of 23 percent compared to the current benefit formula would leave this worker with a replacement rate from Social Security of roughly 28 percent ($.77 * .36$).

benefit and revenue changes that would retain the program's critical role in delivering a solid foundation of financial security.³²

³² For one plan that achieves sustainable solvency without the severe benefit reductions implied by price indexing, see Peter A. Diamond, and Peter R. Orszag, *Saving Social Security: A Balanced Approach* (Washington: Brookings Institution Press, 2004).