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Bush Plan Does Not Solve Social Security Problem

In his State of the Union address, President Bush made a bold proposal to reform Social Security. Arguing that Social Security is facing a financing crisis in the years and decades to come, President Bush proposed the creation of private accounts for workers born in 1950 or later to lessen the financial strain ahead. The President's proposal has a number of inconsistencies that make it structurally weak.

First, the plan does not address the source of the Social Security problem, which is that the benefits promised far exceed projected revenues over time. Although it is now running a surplus, the Social Security actuaries project that the system will begin paying out more than it takes in by 2018; and by 2042 it will exhaust all of its reserves (Display 1).

The President's proposal to create private accounts would require the federal government to borrow a huge amount of money to cover all of the Social Security payments owed to current recipients. The reason: The current Social Security system is a "pay-as-you-go" system, in which the payroll taxes of current workers finance benefits for current retirees. Thus, if some workers are allowed to divert part of their current payroll taxes to private accounts, the federal government will have to borrow to pay the benefits owed to current and future retirees.

The Administration estimates that the transition financing cost will be $664 billion over the next 10 years ($754 billion including interest). The proposal assumes, however, that private accounts will begin in 2009. The full transition cost over the first 10 years *after inception* is likely to exceed $1 trillion. Adding such vast sums to a federal deficit that is already estimated to be over $400 billion in Fiscal Year 2004 will make it difficult to get Congress to go along with the President's plan.

The Administration would argue that over the longer run there is no additional government borrowing associated with the creation of private accounts because as participants in the new program begin to retire, their old-fashioned Social Security benefits would be reduced by roughly the amount that they had invested in their new, private accounts. That might well be true, but if Social Security revenues and benefits are reduced by an identical amount, the root of the future financing shortfall (too few tax dollars to support too many benefits) has not been addressed. In other words, the creation of private accounts does nothing to solve Social Security's long-term financial problems.

An Overstated Problem

Second, Social Security's financial problems are overstated. The shortfall projected over the next several decades is due to the actuarial projection that the economy will not generate enough growth and tax revenue to pay the benefits promised: The Social Security actuaries assume that real economic growth will average 1.9% per year over the next 75 years, about half the 3.5% average annual growth rate over the past 75 years. Similarly, the Congressional Budget Office assumes 2.0% real economic growth. While demographic trends do point to a Social Security deficit ahead, it is likely to occur later and be smaller than projected because over the long term, economic growth is likely to be closer to historical norms.

Note that the President's proposal assumes a 6.5% return for stocks and a 3% real return for bonds that doesn't fit the economic assumptions in the actuarial forecast. With the current price-earnings ratio close to its historical average, it is hard to see how the real return on stocks could run three times faster than the growth in real growth and real profits over the next several decades. Either the real economic growth forecasts that underlie the actuarial projections on Social Security are too low, or the returns projected for the private retirement accounts are too high. We think it's the economic growth forecasts that are off.

Third, the President is asking workers to give up a *guaranteed* benefit for a private account with the *potential* for higher returns. Workers will only end up better off if they take more risk—and the markets

The Bush Plan in Brief

Under President Bush's plan, personal retirement accounts would become available in 2009 for some workers and the yearly contribution would increase over time, with a ceiling of 4 percentage points of their payroll taxes.

Initially, participation would be phased in. In the first year, workers between 40 and 54 would have the option of creating private accounts. In the second year, the range would widen to include workers between the ages of 26 and 54 and by the third year, all workers younger than 54 would be eligible to participate.

In the first year, the annual contributions would be capped at $1,000; the cap would increase in increments of $100 per year, plus the growth in average wages. Personal accounts would be opened on a voluntary basis. Those workers that choose to set one up would have ownership and control and could pass on their accounts to their survivors. They could not, however, tap the funds prior to retirement and would have to abide by a schedule of phased withdrawals at retirement.

Participants would be able to invest in a variety of bond and stock funds. The Administration plans to offer individuals a small number of diversified index funds that are currently offered to Federal employees in a program known as Thrift Savings Plan.

are in their favor. This is a fundamental change from Social Security's founding mission of providing a "safeguard against the major misfortunes of life." Early polls show that the vast of majority of workers are not ready to abandon the current system and give up that guaranteed Social Security payment.

Nonetheless, some sort of Social Security reform is likely to take place this year or next because there is widespread agreement that Social Security is not on a sustainable course. There are several potential solutions.

Other Possible Solutions

Raise the Retirement Age: When Social Security was introduced in 1935 the average life expectancy was 60 years, so many people did not live long enough to collect any Social Security benefits. Today, life expectancy is 77 years, and many people are retiring before 65. The combination of longer life spans and earlier retirement means that Social Security collects payroll taxes for fewer years but pays out benefits for many more years. Given that life expectancy is expected to increase over the next few decades, it would make sense to increase the retirement age and reduce workers benefits if they retire before the normal retirement age. Estimates show that gradually raising the normal retirement age to 70 would eliminate half of the long-term funding deficit.

Link Benefits to Inflation, not Wages: Social Security benefits are linked to wage growth, not inflation. Since wages tend to run faster than prices, real benefits tend to grow. Linking future benefits to inflation, rather than wage growth, would thus reduce the long-term financing problem.

Introduce a Means Test: Some observers have also suggested than Social Security introduce a means test, whereby benefits would be reduced or eliminated for participants whose wealth or income exceed specified thresholds. This, however, would run counter to the program's guiding principle: that Social Security benefits are an earned right, not a form of need-based welfare.

Simply raising the retirement age and linking benefits to inflation would require no transition funding, would be easy to implement gradually and would go a long way toward shoring up the long-term financial problems of the Social Security system.

If the President wants to create private accounts for younger workers, there's another, far easier way to do so: Require employers with a workforce above a certain size to make investing in 401(k) retirement plans mandatory for new, full-time employees. This would both increase private saving and increase private ownership and control of retirement savings—without the government borrowing included in the President's plan.

There is no simple solution to the Social Security financing problem. But a series of small changes, if made soon, would go along way in alleviating the problem.

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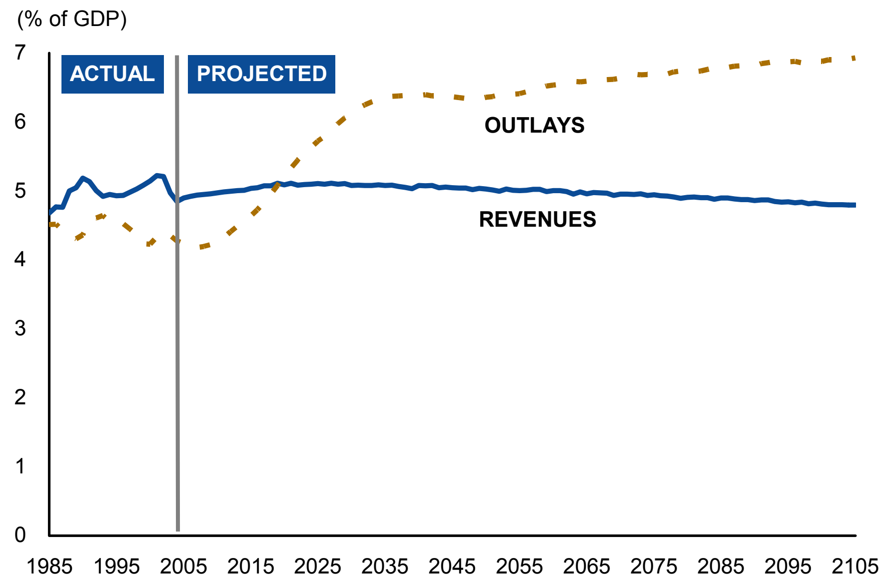
Display 1: CBO Projections Show Social Security Will Run an Annual Deficit within 15 Years

Social Security Revenues and Outlays as a Share of GDP, 1985 Through 2105 (Scheduled Benefits)

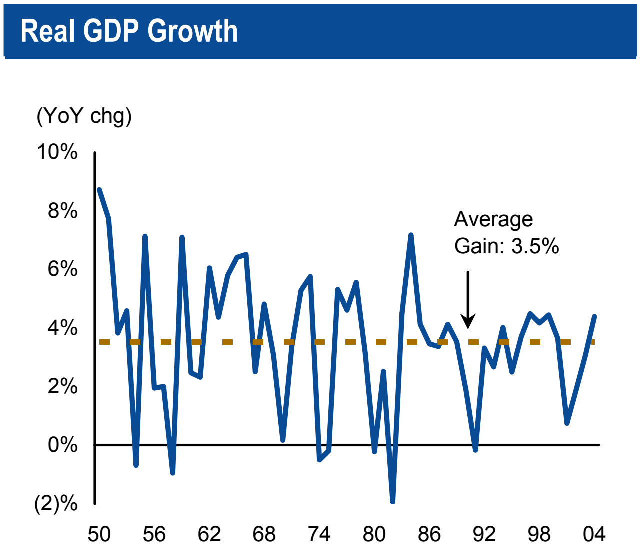


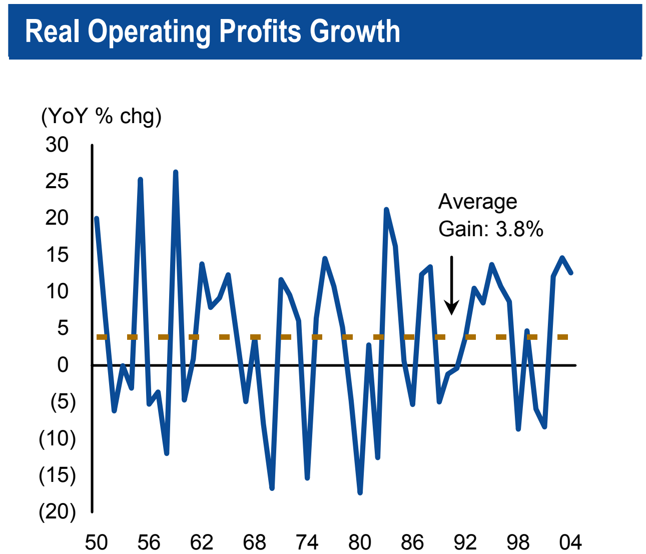
Note: Based on a single simulation using the Social Security trustees' 2004 intermediate demographic assumptions and CBO's August 2004 economic assumptions. Revenues include payroll taxes and income taxes on benefits but not interest credited to the Social Security trust funds; outlays include scheduled Social Security benefits and administrative costs. Under current law, outlays begin to exceed revenues starting in 2020; starting in 2053 scheduled benefits cannot be paid. Under Diamond-Orszag, outlays begin to exceed revenues in 2022, but fall below revenues in 2056.

Source: Congressional Budget Office, February 25, 2005

Actuarial projections of the Congressional Budget Office indicate that the Social Security system will start running a cash deficit by 2020; the Social Security actuaries say 2018. Both project the deficit's size will grow over time. We don't think the long-term financing picture is that gloomy, because the economic assumptions that underlie these projections are much too conservative.

Display 2: History Shows Close Match Between Growth in Real GDP and Real Profits





Source: Bureau of Economic Analysis, Haver Analytics and Alliance Capital Fixed Income, February 25, 2005

Real GDP growth has averaged 3.5% per annum since 1950; real profit growth has averaged 3.8%. Given these historical averages, we think real GDP growth projections of 1.9% over the next several decades looks too conservative.