Institute For Policy Innovation IPI

ISSUE BRIEF

Summary: *Some suggest that proposals for Social Security reform should be judged by the degree to which they require general revenue financing. But this flawed yardstick is biased against personal account plans, because it doesn't accurately measure transition costs, and doesn't account for the dramatically increased benefits of personal accounts. The only way to evaluate reform plans is to weigh all of the costs against all of the benefits.*

Social Security Reform:

Half Measures and Mismeasures

By Peter Ferrara

Some Social Security reform analysts have adopted as the yardstick for evaluating reform plans *the degree to which a plan requires general revenue financing*. More makes the plan bad and less makes the plan good. At least one analyst has said that this measure is the way to rank various proposals.

But this yardstick is not a comprehensive measure of either the costs or the benefits of reform. Moreover, it is biased against personal accounts, particularly larger accounts. Consequently, it is not a valid summary yardstick that can be used to rank alternative reform proposals.

The Transition Financing Burden

In any personal account reform plan, as workers shift part of their payroll taxes into the accounts, transition financing is needed to replace those taxes so that full Social Security benefits can continue to be paid. As the accounts phase-in, and increasingly bear the burden of financing retirement benefits, the need for transition financing phases out.

Some of the transition financing burdens can be covered by the short-term surpluses in Social Security, now projected to continue until 2018. Those funds are internal to the program and are not considered general revenue financing. Covering transition financing by raising Social Security taxes or cutting Social Security benefits is also not considered general revenue financing.

From the beginning of the personal account reform movement, publications from the Cato Institute, the Heritage Foundation and others have said the transition financing would come from general revenues. These general revenues could be generated either by reducing the growth of other Federal spending and using the savings for the transition, or by increasing general tax revenues.

In addition, the transition can be financed to some degree through increased government borrowing. Such financing can help to cover the transition costs in the early years of the reform, and can be paid off in the later years.

Not an Accurate Measure of Costs

Measuring the different reform plans only by the degree of general revenue financing required does not accurately account for all of the costs of the different plans. Cutting Social Security benefits is not considered a cost under this faulty measure, nor is raising Social Security taxes. But cutting other government spending to finance the transition is counted as a cost, as is raising general tax revenues. There is no substantive reason for counting the latter, but not the former. They both involve directing equivalent amounts of resources to the transition.

Moreover, a reform plan can have positive economic effects that *increase general revenues without raising tax rates*. These new revenues can then be devoted to the transition. Using only the amount of general revenues required by a reform plan as the yardstick would count this as a cost of the plan. But it is not a cost because it involves revenues that were generated *by the reform itself* and would not exist without the reform.

> *Evaluating reform plans solely by the yardstick of how much general revenue financing is required is biased against personal account plans, as it does not account for the increased benefits.*

For example, the Progressive Personal Account Reform Plan published by IPI has been scored by the Chief Actuary of Social Security as utilizing $6.2 trillion in general revenues in present value terms. But the Actuary's score also shows that 54% of those revenues *are generated by the plan itself* through corporate tax revenue feedback. Companies would use the money they obtain by selling stocks and bonds to the accounts to invest in new ventures that earn new returns. These new returns would be subject to taxation at the business level, generating new revenues. So those who purport to measure the cost of the Progressive Personal Account Reform plan by looking only at the amount of general revenues it uses are overstating the costs by more than a factor of two.

Doesn't Count the Benefits

The amount of general revenues utilized by a reform plan does not tell us anything about the benefits of the reform plan. Shifting to personal accounts would provide higher retirement benefits because capital market investment returns are so much higher than what uninvested, purely redistributive, pay-as-you-go Social Security can pay. And the larger the personal accounts, the higher the benefits.

Evaluating reform plans solely by the yardstick of how much general revenue financing is required is consequently *biased against personal account reform plans*, as it does not account for these increased benefits. The bias is even larger against bigger accounts because the benefit improvements not considered are even larger.

Moreover, all personal account reform plans involve building up huge amounts of assets in personal accounts directly owned by each worker. But evaluating reform plans solely by the yardstick of general revenue transfers to Social Security again fails to consider this huge benefit. Consequently, the yardstick is again biased against all personal account plans, more so the larger the account.

The gross failure of the general revenue financing yardstick to evaluate and rank different reform proposals can be seen quite clearly through some specific examples. The reform plan advanced through the Brookings Institution by Peter Orszag and Peter Diamond eliminates long-term Social Security deficits by cutting Social Security benefits and raising Social Security taxes. Since it does not involve any general revenue financing, it is ideal if reforms are to be evaluated and ranked solely by the amount of general revenue financing. By contrast, the Progressive Personal Account Reform Plan advanced through IPI is again scored as requiring general revenue transfers of $6.2 trillion in present value terms. Under only the yardstick of general revenue financing, that would make it an inferior proposal as compared to Orszag-Diamond.

But the personal accounts in the IPI plan would increase future benefits for working people substantially, in the range of 60% to 70% for those who contribute to the accounts over their entire lives. The reform would also produce a reduction in the payroll tax rate all the way down to 3.5%, as officially scored by the Chief Actuary. Moreover, the score shows that the reform produces accumulated wealth in the personal accounts of working people of over $7 trillion in present value dollars. None of this is considered solely by evaluating the plan by amount of general revenues it requires.

As another example, if the projected Social Security deficits were covered simply by devoting general revenues to Social Security to the extent necessary, $3.5 trillion in general revenues (in present value dollars) would be required for the program over the next 75 years. Can we then fairly conclude that the Progressive Personal Account plan is undesirable because it would require more in general revenues? Some analysts seem to suggest so.

But that evaluation would fail to consider the much higher retirement benefits that would be produced by the Progressive Personal Accounts. It would fail to consider the over $7 trillion in present value dollars in increased wealth directly owned by working people in their own accounts through the reform plan. It would fail to consider the sharp reduction in payroll taxes produced by the reform plan. It would also fail to consider that about 54% of the general revenues used by the Progressive Personal Account Plan are self generated, so the plan would in reality require less in net general revenue financing than supplying general revenues for the current Social Security system, even while providing the above enormously greater benefits.

Let's apply the same methodology as the general revenue-financing yardstick to a concrete personal example. Consider Mr. A, who currently rents an apartment for $1,500, but faces a rent increase of $100 a month to $1,600. He decides he wants to buy a house instead with a monthly payment of $3,200. He comes to his friend, Mr. B, who recently left a major think tank to take a job in policy at the Social Security Administration, and asks him to help evaluate the idea. Mr. B tells him that under the new housing proposal, the present value of the personal income transfers to his housing fund would be 2Y, while if he just contributed the personal income transfers necessary to finance his current apartment, the present value of those transfers would only be Y. Left out of the calculation is the fact that with the house Mr. X would own a huge asset, after 30 years the mortgage would be paid off, and the house is a lot nicer than the apartment.

The only way to evaluate and rank reform plans is to weigh all of a plan's costs against all of a plan's benefits.

Any plan that involves shifting from a pay-as-you-go Social Security system to a fully funded system like personal accounts naturally involves additional up-front funding to make the savings involved in the full funding. That is more than offset, however, by the vast long-term benefits of the reform. Yet, evaluating all reforms solely by the degree of general revenues required counts any general revenue transfers to finance the transition to the increased savings as a cost, yet counts none of the benefits. Such an evaluation methodology is consequently inaccurate and heavily biased against personal account proposals.

The degree of general revenues required is not a full measure of either a personal account plan's costs or its benefits. It is a measure of some of a plan's costs while taking no account of the plan's benefits. So it is not a valid summary statistic that can be used to rank the alternative reform proposals.

A Full Evaluation

The only way to evaluate and rank reform plans is to weigh all of a plan's costs against all of a plan's benefits. The full costs and benefits of the Progressive Personal Account Plan have been presented in several publications. The inputs are:

1. Devote the short-term Social Security surpluses now projected until 2018 to the reform plan.
2. Reduce the rate of growth of Federal spending by one percentage point each year for 8 years, with the savings devoted to the reform plan. The proposal would consequently involve a Federal spending limitation measure providing for this reasonable and moderate spending restraint. The proposal, therefore, provides a vehicle for beginning to get runaway Federal spending under control.
3. The reform produces increased corporate tax revenues due to new corporate income resulting from corporate investment of the growing personal account savings. These funds would also be devoted to financing the transition.
4. To the extent needed each year, excess Social Security trust fund bonds would be sold to the public with the funds used to ensure payment of full Social Security benefits. This is what those trust fund bonds are for. Under the current system, those bonds are just going to be redeemed for cash from the Federal government anyway after 2018, until the trust fund is exhausted in 2042.

Moreover, after Social Security achieves solvency, the surpluses produced by the reform are sufficient to pay off this debt sold by the public within the next 15 years. So the net effect of the reform on debt held by the public is zero.

The outputs produced by the reform plan in return for these inputs are:

- The reform plan achieves full solvency in Social Security by 2029, with permanent and growing surpluses thereafter, all without any benefit cuts or tax increases.
- Indeed, the Chief Actuary actually scored that the permanent surpluses in Social Security thereafter are so large the payroll tax rate can be reduced from 12.4% down to 3.5%, with 6.4 percentage points again going into the accounts on average. Under the current system, the Chief Actuary has also scored that under intermediate assumptions the payroll tax rate would have to rise to over 20%. Bottom line: the plan involves *the largest tax cut in world history.*
- At the same time, the accounts in the plan are large enough that at standard market investment returns they would provide workers across the board with higher benefits than Social Security even promises, let alone what it can pay.
- As a result, through the large personal accounts, not only would the long term financing crisis of the program be eliminated without raising taxes or cutting benefits. The reform would actually solve the financing crisis while cutting taxes and increasing benefits. That should not be a surprise. That is what happened in Chile as well. That

results because the accounts produce a large increase in national wealth and income, through increased savings and investment, and lower taxes.

- In addition, the Chief Actuary also estimated under the reform plan that the personal wealth of working people is increased by over $7 trillion in present value dollars through the accounts. This would greatly broaden the ownership of wealth, which should appeal to both conservatives and liberals.
- Moreover, in the process of shifting reliance to the personal accounts, the unfunded liability of Social Security, currently officially estimated at $10.5 trillion, would be eliminated. This is three times the current reported national debt. Bottom line: this would be *the largest reduction in effective government debt in world history.*

It is not a rebuttal to this analysis to restate any of the costs in out-of-context constant dollar terms, or to consider the inputs but not the outputs. The question is whether the public would consider the outputs to be a good tradeoff for the inputs. I suggest that quite transparently they would.

About the Author

Peter Ferrara is a Research Fellow with the Institute for Policy Innovation (IPI), and President of the Virginia Club for Growth. He served as a senior staff member in the White House Office of Policy Development under President Reagan and as Associate Deputy Attorney General of the United States under the first President Bush. He is a graduate of Harvard College and Harvard Law School, and has practiced law with firms on Wall Street and in Washington, DC. He wrote the first book for the Cato Institute providing a comprehensive intellectual foundation for a personal account option for Social Security, Social Security: The Inherent Contradiction (1980), and has continued to write on that concept in further books, studies and articles for Cato, the Heritage Foundation, the National Center for Policy Analysis, the Family Research Council, the U.S Chamber of Commerce, and a wide range of other institutions and publications.

About the IPI Center for Economic Growth

Few public policy issues are as critical as sustained economic growth. Through the IPI Center for Economic Growth, the Institute for Policy Innovation pursues policy changes designed to increase levels of stable, predictable economic growth. The Center believes that critical lessons were learned during the 20th Century (particularly during the 1980s and 1990s) about how private property, government regulation, tax policy and monetary policy contribute to or undermine economic growth, and seeks to apply those lessons to 21st Century policy issues. The Center advocates protection of private property, deregulation, competition, innovation, entrepreneurship, stable currency, and low tax rates as means to achieving sustained high levels of economic growth, and denies that there is any public policy downside to high levels of economic growth.

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The Institute for Policy Innovation (IPI) is a non-profit, non-partisan educational organization founded in 1987. IPI's purposes are to conduct research, aid development, and widely promote innovative and non-partisan solutions to today's public policy problems. IPI is a public foundation, and is supported wholly by contributions from individuals, businesses, and other non-profit foundations. IPI neither solicits nor accepts contributions from any government agency.

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Editor & Publisher . . . . Tom Giovanetti

IPI *Issue Brief* is published by the Institute for Policy Innovation (IPI), a non-profit public policy organization.

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