Institute For Policy Innovation IPI

ISSUE BRIEF

Summary: *Synopsis: The enormous benefits of Social Security reform involving large personal accounts is quite achievable, as is the proposed transition financing. A manageable amount of debt would be issued in the early years and paid off during the course of the reform. The reform plan would promote modest restraint in the growth of other federal spending, and should produce significant revenue feedback effects.*

Proving Large Personal Retirement Accounts Work

By Peter Ferrara

Last December, the Chief Actuary of Social Security released an official score[1] of a Social Security reform plan I authored for the Institute for Policy Innovation (IPI), which proposed a large personal account option for Social Security.[2] Workers choosing the option would devote on average 6.4 percentage points of the current 12.4% Social Security payroll tax to their own, personal, investment account.[3]

The score showed that the large accounts would take over so much responsibility for the payment of retirement benefits over time that eventually the long term deficits of Social Security would be eliminated through the accounts alone, without cutting benefits or raising taxes. Indeed, at standard market investment returns, the accounts would pay much higher benefits than Social Security promises (but cannot pay).[4]

Moreover, the score showed that under the large account plan the payroll tax would eventually be reduced to 3.5%, instead of increasing to over 20% to pay all promised benefits under the current system. This would be the largest tax cut in world history.

New Data

Nevertheless, there has been considerable confusion over the exact amount of transition deficits and debt resulting under the plan, even though those could be directly calculated from the data in the original score. Last April, however, the Chief Actuary released an addendum to the original score of the IPI plan that clarifies these issues.[5] (see www.ipi.org or www.ssa.gov).

The addendum presents the exact amount of net additional Social Security Trust Fund bonds that would have to be redeemed under the plan each year, as shown in the accompanying Table A. Under the reform plan, the redemption of these bonds would be financed by selling federal debt to the public. The amount of these redemptions can be calculated precisely by the Chief Actuary because the reform plan specifies 3 sources of financing for the transition besides this debt. These are:

1. Devoting the short term Social Security surpluses now projected until 2018 to the transition;

2. General revenue **contributions** to Social Security each year equal to the savings that would be derived by reducing the rate of growth of federal spending by 1% for each of 8 years;[6]

3. General revenue contributions to Social Security each year equal to the estimated revenue feedback from corporate investment of the funds derived from the sale of stocks and bonds to the personal accounts.[7]

Table A The Progressive Personal Account Plan

Social Security Trust Fund Bonds Redeemed to Cover Social Security Deficits (All figures in billions)

Year	Constant 2003 Dollars	Present Value Dollars
2005	144	130
2006	131	115
2007	109	93
2008	89	74
2009	70	56
2010	51	40
2011	30	23
2012	10	8
2013	17	12
2014	24	16
2015	30	20
2016	36	24
2017	42	26
2018	47	28
2019	50	30
2020	53	30
2021	55	31
2022	56	30
2023	53	28
2024	49	25
2025	42	21
2026	34	16
2027	23	11
2028	9	4
Total		**891**

Source: Office of the Actuary, Social Security Administration

If the Social Security surpluses, spending restraint, and corporate revenue feedback specified in the reform plan are actually produced to finance the transition, then the amounts in Table A are equal to the total net debt that would have to be issued to the public under the reform plan to cover all remaining Social Security deficits. As Table A shows, the issuance of this debt would end in 2028, with Social Security going into permanent surplus under the reform plan after that point. The total debt would consequently amount to about $900 billion in present value dollars.

Most importantly, the Chief Actuary's original score of the reform plan shows that the surpluses beginning in 2029 would be sufficient over the next 15 years to pay off all of this debt issued in previous years. As a result, the net increase in Federal debt under the reform plan is zero.

Shockingly, Empower America Chief Economist Larry Hunter has calculated that if the Social Security deficits starting in 2018 under the current system are covered simply by issuing new debt to pay off the Social Security trust fund bonds as they are redeemed, then by 2028 the accumulation of public debt under the current system would be close to the same as under the proposed large account reform.[8] But, again, under the reform plan, that debt would be paid off over the following 15 years. Under the current system, by contrast, that debt would not be paid off, but would continue to grow **indefinitely** to **more than** 300% of GDP, and beyond.

In addition, the reform plan would eliminate the unfunded liability of Social Security, officially estimated today at $10.5 trillion, three times the reported net national debt. The reform would consequently ultimately achieve the largest reduction in government debt in world history.

Smaller Net Transition Deficits

In discussing the data in the addendum to the official score of the reform plan, the Chief Actuary pointed out that the amounts in Table A include the impact of the Social Security deficits starting in 2018. This means that we have been overstating the net transition deficits that would result from the personal account reform plan by itself. If the transition financing specified in the reform plan - the short term Social Security surpluses, the spending restraint, and the corporate revenue feedback - is, in fact, produced, then the net transition deficits resulting from the large personal account reform plan itself are shown in Table B. The totals in Table B equal the totals in Table A minus the net Social Security deficit beginning in 2018 under the current system.

Table B The Progressive Personal Account Plan

Net Annual Transition Deficits (All figures in billions)		
Year	Net Transition Deficit Constant 2003 Dollars	Net Transition Deficit Present Value Dollars
2005	144	130
2006	131	115
2007	109	93
2008	89	74
2009	70	56
2010	51	40
2011	30	23
2012	10	8
2013	17	12
2014	24	16
2015	30	20
2016	36	24
2017	42	26
2018	27	24
2019	12	26
Total		**660**

These transition deficits are quite modest given the enormous magnitude of the reform and its sweeping benefits. With the transition financing, the net deficits last only 15 years, and total $660 billion in present value dollars. In constant dollars, the deficits fall below $100 billion after the first three years and below $70 billion after the first 5 years, averaging only $55 billion over the 15-year period. Issuing debt to cover these net transition deficits would involve only borrowing back a minor portion of the savings accumulated in the accounts, which under the Chief Actuary's score accumulate to $7 trillion by 2020 in constant dollars. And, again, even that minor borrowing is soon paid off.

The reform plan also provides that Social Security revenues, expenditures, surpluses and deficits are to be accounted for in their own separate Social Security lockbox budget separate from the rest of the Federal budget. This would permanently stop the raid on the Social Security surpluses and trust funds to support spending in the rest of the federal budget. Instead, the short term surpluses would be devoted solely to financing Social Security benefits and personal account reform.

With Social Security revenues and expenditures out of the rest of the budget, the net transition deficits from the reform shown in Table B would be separated from the rest of the Federal budget and its deficits as well. **These transition deficits would consequently not increase the deficit in the rest of the budget.** The general revenue transfers to Social Security for the spending restraint and corporate revenue feedback would be on budget. But if the specified spending restraint and increased revenues are achieved, then these transfers would not increase the on-budget deficit either.

The debt issued to finance personal account reform would also be held in its own separate fund with the debt slated to be paid off out of the later surpluses resulting from the reform. These later surpluses would also be separate from the rest of the budget in the Social Security lockbox budget. So they would also be protected from raids to finance other spending, and would be devoted instead to paying off the earlier issued debt. The separate account for the accumulated transition debt would serve as a scorecard to show whether that debt has, in fact, been paid off.

This is the proper budget accounting for the reform. Unlike the deficit in the rest of the budget, the reform plan's net transition deficits are not adding new Federal debt and liabilities. The reform plan is instead actually reducing long term federal liabilities dramatically, ultimately eliminating the unfunded liabilities of Social Security. The shorter term debt resulting from the reform plan, moreover, is just recognizing debt the government already owes through Social Security's unfunded liability, and even that is fully paid off under the reform plan. Finally, again unlike the deficits in the rest of the budget, the reform plan's net transition deficits do not reflect a net drain on national savings. The debt issued to cover those transition deficits only involves borrowing back part of the savings generated through the personal accounts, quite likely producing a large increase in national savings overall.

So it would actually be quite misleading to account for the net transition deficits under the reform the same as for any deficits in the Federal government's general operating budget. The net effect of the reform and its transition deficits on the economy and the Federal debt is actually the opposite of the net effect of general Federal budget deficits.

Most Desirable Transition Financing

Restraining the growth of Federal spending is the best possible way to finance the transition and personal accounts. To the extent the foregone additional Federal spending is wasteful or even counterproductive, such spending restraint is, in fact, an additional benefit of the reform, not a cost.

The degree of spending restraint provided in the reform plan - reducing the rate of growth of federal spending by just one percentage point in each of 8 years - is quite feasible. Americans for Tax Reform Chief Economist Dan Clifton has pointed out that about the same degree of spending restraint was, in fact, achieved during the 8 years of the Clinton Presidency, with the able assistance of the Republican Congress. During those 8 years, Federal spending grew by 3.6% a year, while the long run CBO baseline assumes annual spending growth of 4.8%. Indeed, over that 8 year period GDP grew by 5.4% a year, and that would be a more reasonable baseline estimate of Federal spending growth, following the historical record going back decades. On this baseline, Clinton achieved more spending restraint during his 8 years than called for under the reform plan.

In addition, Bush's new Fiscal 2005 budget proposed to reduce the rate of growth of federal spending for the next fiscal year three times as much as proposed in the reform plan. Over the first 3 years of the Bush presidency, federal spending grew by 7.2% a year. But the new Fiscal 2005 Bush budget proposed a federal spending increase for next year of only 4%.

Indeed, Club for Growth President Stephen Moore recently detailed in a study for the Institute for Policy Innovation (IPI) the desirability of far greater future spending reductions than called for in the personal account reform proposal.[9] The Cato Institute's Director of Fiscal Policy Chris Edwards recently did the same in a Cato paper.[10] The Heritage Foundation also has well developed budget savings proposals that would achieve several times the spending restraint required by the personal account reform proposal.

Legislation to implement the personal account plan would serve as a vehicle for achieving those budget savings, making them far more likely. That legislation will include a national spending limitation measure, like the spending growth limits adopted by many states. Moreover, the budgetary pressure of financing the transition to large personal accounts would, in fact, help to drive the achievement of the spending restraint. As Milton Friedman and many others have argued, the best way to reduce spending growth is to reduce the funds available for such spending. That is what the proposed reform plan does.

Moreover, the enormous benefits of the reform for workers would also change the public choice dynamic now favoring runaway spending. The average voter today does not have sufficient interest in restraining any particular spending program, while the special interests benefiting from that spending have a powerful concentrated interest in supporting runaway increases. But with the spending restraint as part of a much larger reform for personal accounts with enormous benefits for workers across the board, the general public would become much more directly involved and activated in supporting the necessary spending restraint to finance the reform. Effectively, every dollar of spending restraint under the reform is going into the pockets of working people across the country in their personal accounts. As a result, the reform plan again becomes a vehicle for driving spending restraint.

Finally, Hunter shows that the amount of spending restraint proposed in the reform plan is exactly the restraint that must be achieved in order to balance the federal budget while making the Bush tax cuts permanent. Hunter calculates that making the Bush tax cuts permanent, and correcting the Alternative Minimum Tax so it doesn't spread from the rich to the general public, would leave federal revenues stabilized over the long term at about 18.4% of GDP. But the 8 years of spending restraint under the reform plan would also reduce federal spending from the current level of about 20% of GDP to 18.4% of GDP. So this is a reasonable and modest amount of spending restraint that must be adopted in any event to achieve the goals of current national economic policy.

Indeed, keeping the federal budget balanced at about 18.4% of GDP would ultimately require much greater long term spending restraint than required in the reform plan. The reform plan provides that the budget savings achieved during the 8 years of spending restraint would be maintained until the short term debt issued to finance the transition is paid off. This would keep federal spending below the long term trend line by about 1.6% of GDP for an extended period. But starting about 15 years from now, that long term federal spending trend line starts increasing quite rapidly relative to GDP. CBO projects that on our current course Federal spending would reach 32.8% of GDP by 2050. The spending restraint to finance the reform plan would provide the foundation to reduce that, again, by only 1.6 percentage points, to 31.2%. To keep federal spending at 18.4% of GDP would require other long term spending reforms besides the proposed Social Security personal account reform plan.[11]

The bottom line is that the financing needed for the reform, and all of its sweeping benefits, can be achieved through the modest spending restraint proposed in the reform. The reform plan with such spending restraint is surely highly desirable.

The transition financing that would be provided through the corporate revenue feedback is again based on the work of Harvard Professor of Economics Martin Feldstein, Chairman of the National Bureau of Economic Research. This corporate tax revenue feedback was first scored for the personal account reform plan proposed by former Sen. Phil Gramm years ago. This is just one of the positive economic effects of the reform, which the work of Feldstein and others shows would be far more extensive.[12] So a complete revenue feedback from all of these effects would actually be much larger. This would leave the actual net transition deficits much smaller.

Some analysts insist that such transition financing is somehow "too costly." They want to rank reform plan costs by the amount of general revenues that would be transferred to the Social Security trust funds to finance the transition. But such general revenue transfers are not remotely an accurate measure of a reform plan's net costs.

About half of the transition financing for the proposed IPI reform plan comes from the corporate revenue feedback. This would be counted as a general revenue transfer to the Social Security trust funds. But these revenues are produced by the reform plan itself. They would not exist without the reform plan. Consequently, this funding is not a net cost of the reform. To the contrary, it is another benefit produced by the reform.

Similarly, the remaining net transition financing over the life of the reform comes from the reduced spending growth. This would also be counted as a general revenue transfer to the trust fund. But to the extent such spending restraint is achieved by reducing wasteful or counterproductive government spending, this is also not a cost of the reform in a true sense of the word "cost." Rather, eliminating such spending is actually another benefit of the overall reform plan.

Moreover, reductions in future Social Security benefits are not counted as general revenue transfers to the trust funds. So using general revenue transfers as the measure of costs would not count such benefit reductions at all. But Social Security benefits cannot be considered wasteful or counterproductive government spending. So such future benefit reductions are actually a true cost of any reform plan that includes them.

Consequently, general revenue transfers to the trust fund to finance the transition are a confused and misleading measure of the costs of a personal account reform plan.

Conclusion

The transition financing proposed for the large personal account reform plan is quite feasible. A manageable amount of debt would need to be issued in the early years of the reform, and even that would be paid off during the course of the reform. The financing plan is based on a modest and readily achievable degree of restraint in the growth of other federal spending, which the reform plan itself would greatly help to promote. The reform plan overall should also produce much greater growth and revenue feedback effects than specified in the reform plan's transition financing. But even the specified feedback effects would leave manageable net transition deficits, financed by the temporary debt noted above, which would be properly accounted for in their own separate, Social Security lockbox budget. That would separate Social Security and its reform from the deficits and debt arising from the rest of the federal budget.

The enormous, historically sweeping benefits of Social Security reform involving large personal accounts are consequently quite achievable.

Endnotes

1. Estimated Financial Effects of the Progressive Personal Account Plan, December 1, 2003, Office of the Actuary, Social Security Administration, www.ssa.gov; www.ipi.org.
2. Peter Ferrara, A Progressive Proposal for Social Security Personal Accounts, Institute for Policy Innovation, Policy Report 176, June, 2003.
3. The proposed accounts would be progressive, with workers able to devote to the account 10 percentage points of the current 12.4% Social Security payroll tax on the first $10,000 of wages each year, and 5 percentage points of the tax on all taxable wages above that. That works out on average to 6.4 percentage points of the current 12.4% tax for each worker.
4. Id., pp. 13-15.

5. Additional Estimated Financial Effects of the Progressive Personal Account Plan, April 6, 2004, Office of the Actuary, Social Security Administration, www.ssa.gov; www.ipi.org
6. The Chief Actuary does not certify that such spending savings would be achieved, but the reform plan specifies that this amount of general revenue would be transferred to Social Security in any event, regardless of whether the spending restraint is achieved.
7. The personal accounts would generate a huge influx of cash to corporations selling stocks and bonds to the accounts. The corporations would use that cash to invest in new plant and equipment and business ventures. This investment would produce new income that is taxed at the business level, producing new tax revenues. The estimate of this effect in the score of the reform is based on the work of Harvard Professor of Economics Martin Feldstein, Chairman of the National Bureau of Economic Research. The Chief Actuary again does not certify that the estimated amounts of revenue feedback would actually occur, but the reform plan provides that the estimated amount of general revenues would be transferred to Social Security in any event.
8. Hunter calculates that the accumulation of such debt under the current system by 2028 would be about 90% of the projected accumulated debt under the reform plan.
9. Stephen Moore, Putting Taxpayers First: A Federal Budget Plan to Benefit the Next Generation of Taxpayers, IPI Policy Report 74, February 17, 2004.
10. Chris Edwards, Downsizing the Federal Government, Cato Policy Analysis No. 515, June 2, 2004.
11. Those who have argued that the spending restraint proposed in the reform plan is quite draconian assume that the restraint would keep Federal spending at about 18.4% of GDP permanently. But, as discussed above, that is erroneous. The plan would just maintain the spending savings equal to 1.6% of GDP until the short term transition debt is paid off. Even with that savings maintained, the long term trend of Federal spending would still grow to over 30% of GDP and beyond, without further reforms.
12. Peter Ferrara and Michael Tanner, A New Deal for Social Security, Washington, DC: Cato Institute, 1998, Chapter 6.

About the Author

Peter Ferrara is Director of the International Center for Law and Economics 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 Institute for Policy Innovation

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.

IPI's focus is on developing new approaches to governing that harness the strengths of individual choice, limited government, and free markets. IPI emphasizes getting its studies into the hands of the press and policy makers so that the ideas they contain can be applied to the challenges facing us today.

Editor & Publisher . . . . Tom Giovanetti

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

Direct all inquiries to: **Institute for Policy Innovation**
1660 S. Stemmons Freeway, Suite 475
Lewisville, TX 75067

(972) 874-5139 (Voice)
(972) 874-5144 (FAX)
Email: ipi@ipi.org
Internet Website: www.ipi.org