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Summary: *A well-designed personal account option for Social Security would be substantial, highly progressive, and would provide a broad array of advantages for working people across the board. This study provides a concrete, specific and detailed proposal for reform that delivers on the promise of a true personal account option.*

QUICK STUDY

A Progressive Proposal for Social Security Personal Accounts

By Peter Ferrara

The rationale for allowing workers the freedom to choose a personal savings and investment account in place of at least part of their current Social Security coverage is broad, multifaceted and well supported. Benefits include personal ownership, superior returns, progressivity, expansion of the investor class, a tax cut, stronger economic growth, and solving the enormous Social Security liability crisis.

Other countries around the world have adopted personal account options for their Social Security systems, with good results. They include Chile, Argentina, Mexico, Peru, Colombia, Uruguay, Bolivia, El Salvador, Great Britain, Hungary, Poland, Switzerland, Denmark, Sweden, Australia, and Kazakhstan. Both Russia and China are taking steps to move to personal account systems.

The American public seems quite ready to bring such a system to the U.S. For several years, polls have shown startling public support for a personal investment account option for Social Security. Leading opponents of personal accounts said the 2002 mid-term elections would be a referendum on such reform. Yet as national pollster and political handicapper John Zogby reported after the election, "In every race where Social Security was a major issue, the pro-account candidate won."

What is needed now is a specific reform plan that delivers on the promise of personal accounts, benefiting working people as much as possible, including the lowest-income workers and minorities. If the reform is done right, these groups have the most to gain.

A Compass for Reform

Some reformers have been developing proposals with very small personal accounts, allowing workers to shift only about 2 percentage points of the payroll tax to the account, combined with very large reductions in the long-term growth of Social Security benefits. But this approach is badly misconceived.

One of the advantages of personal accounts was always that they could address the long term Social Security financing crisis without cutting benefits or raising taxes. Over time, the accounts would sharply reduce the benefit obligations of the old system, reducing the program's deficits and unfunded liabilities. Eventually, we would reach the point where almost all workers are relying on personal accounts for their retirement benefits, eliminating Social Security benefits and unfunded liabilities.

So why unnecessarily mandate Social Security benefit reductions that undermine the whole reform effort? Why hand opponents such red meat to stop reform altogether?

In contrast, a progressive, populist reform plan with a large personal account option and no other changes to the Social Security benefit structure can generate huge, popular, grassroots fervor and political support across the spectrum.

The reform plan proposed here tries to include all the best ideas that have been advanced from many quarters, and ultimately aims to achieve the goals of reform in the most positive, broadly appealing manner.

A Progressive Proposal for Reform

This reform plan would allow workers the freedom to choose to save and invest 5 percentage points of the 12.4 percent Social Security payroll tax in their own personal accounts. On the first $10,000 of income they would be able to double this amount, paying 10 percentage points of the tax into the account. The contributions would come from both the employer and employee shares of the tax.

Such accounts would be quite progressive because of the extra contributions for the lowest portion of earned income. Those entering the work force today could expect the accounts to pay well over 50 percent more than the benefits Social Security promises them.

Private investment fund managers would contract with the U.S. Treasury Dept. to offer investment funds to workers. Each worker would only have the responsibility of choosing among these funds, and the fund manager would pick the particular stocks, bonds or other investments. Unions could sponsor investment fund alternatives to be included among the list of choices, as could membership associations like the NAACP, National Council of La Raza, and AARP.

The portion of the current payroll tax not eligible to be shifted to the personal accounts would continue to be paid for a period of years to help finance the transition. Eventually, this portion of the tax would be phased out, split evenly between employer and employee, for those who exercised the personal account option.

There would be no deduction for contributions to personal accounts, but investment returns would accumulate in the accounts tax-free. Retirement benefits paid from the accounts would be tax-free as well. Any funds remaining at death could be passed to children or other heirs free of the death tax.

The entire system would be backed up by a social safety net guaranteeing that workers would not fall below a minimum floor of benefits equal to what Social Security would have paid them under current law.

Today, those who continue some work after retirement continue to pay Social Security payroll taxes, but they do not get any extra benefits for those taxes. With a personal account, the specified payroll tax contribution would continue to go into the account for any continued work after retirement.

At retirement, workers could choose to use some or all of their funds for an annuity that would pay them a guaranteed monthly income for the rest of their lives. Or they could choose to make periodic withdrawals subject to Treasury Dept. regulations. They could choose retirement and start to receive benefits from the accounts at any point after age 59 ½.

In this plan, only workers age 55 and below can choose to exercise the personal account option.

The Progressive Proposal At A Glance

Basic features of IPI's Progressive Proposal for Social Security Personal Accounts, designed by Peter Ferrara:

- Workers could save and invest 5 percentage points of the 12.4 percent Social Security payroll tax in their own personal accounts. On their first $10,000 of income they would get to save and invest 10 percentage points of the tax into their accounts.
- Private investment fund managers would contract with the U.S. Treasury to offer investment funds to workers.
- Personal account contributions would not be tax-deductible, but investment returns would accumulate tax-free and retirement benefits would be tax-free.
- Funds remaining at death could be passed to children or other heirs free of tax.
- All workers would be guaranteed a minimum benefit equal to what Social Security would have paid them under current law.
- At retirement, workers would convert some or all of their funds into an annuity that would pay them a guaranteed monthly income for the rest of their lives, and could choose to make the conversion at any point after age 59 ½.
- Workers would be free to remain in the current Social Security system.

The transition to the personal accounts would be financed by 4 factors:

- Short-term Social Security surpluses projected until 2018,
- Reducing the rate of growth of Federal spending by 1 percentage point per year for just 8 years, and devoting those savings to the transition,
- Increased Federal revenue from increased saving and investment in the accounts due to taxation of increased investment returns at the corporate level, and
- To the extent needed, the sale of excess Social Security trust fund bonds.

Chief Actuary of Social Security Says the Progressive Plan Works!

The Chief Actuary of Social Security has released an official score of this proposal, which shows that:

- The large personal accounts described in the plan *completely eliminate the Social Security deficit* over time, *without any benefit cuts or tax increases*.
- The accounts produce higher benefits than those Social Security promises.
- The accounts produce a *permanent surplus in Social Security* by themselves and allow for *tax cuts*. By the end of the 75-year projection period, the Social Security payroll tax will be reduced from 12.4% to 3.5%, the *largest tax cut in world history.*
- By eliminating the $10.5 trillion unfunded liability of Social Security, the plan achieves the *largest reduction in government debt in world history.*

The Chief Actuary also found that the proposal manages the transition to personal accounts:

- Social Security will achieve a permanent and growing surplus by 2029.
- The trust fund never falls below 145% of one year's expenditures.
- The reform produces sufficient surpluses to pay off all the bonds sold to the public during the early years of the reform. So the net deficit impact of the reform over the projection period is zero.
- The surpluses are used to *reduce the payroll tax by 2.5 percentage points*, which leaves the payroll tax at 3.5 percentage points, the level needed to finance remaining disability and survivors benefits.

The obvious conclusion from the Actuary's score is that reform proposals should focus on large personal accounts of this magnitude, without benefit cuts or tax increases.

Those already in the work force when they first exercise the personal account option would continue to receive a portion of Social Security retirement benefits based on the taxes they and their employers had already paid into the system in the past.

There would be no change in the Social Security benefits promised under current law, or any other change of any sort, for those retired today, or for anyone near retirement (over age 55).

Indeed, the reform plan would not change or reduce future Social Security benefits either. This includes Social Security disability benefits and survivors' benefits for those who die before age 65, which would continue to be provided as under the current system today.

Workers would consequently be completely free to remain in the current Social Security system as is.

Married workers exercising the personal account option would contribute to a jointly owned account. In retirement, they would draw benefits together as a single-family unit. If the couple divorced, then the account funds at that point would be divided equally between the two spouses, into a separate account for each worker.

Workers in the future would be overwhelmingly relying on the personal accounts rather than Social Security benefits. It makes no sense, therefore, to engage in a bloody and uncertain political fight over what those future Social Security benefits should be. That would just take the focus off of the positive features of personal accounts and greatly dampen much needed grassroots enthusiasm for reform.

Transition Financing

Critics have argued that as workers start devoting some of their payroll taxes to the personal accounts rather than the current Social Security framework, the result would be an immediate financial drain on the trust funds. Politically, a reform plan resulting in earlier net deficits and earlier trust fund depletion is vulnerable to demagoguery from opponents, even if all benefit payments were assured to continue.

There is a simple way to avoid this vulnerability. Under our proposed reform plan, for any Social Security payroll taxes used for personal accounts, bonds representing these amounts would be issued to the Social Security trust funds identical to the bonds that have historically been issued to the trust funds. Those bonds could again be turned in for cash whenever Social Security needed the money to pay promised benefits. This means the personal account reform would not drain any money from the Social Security trust funds.

The government would still need to determine where the general revenues would come from to cover the bonds. President Bush has already proposed to start with the annual Social Security surpluses. Increased tax revenues will also result from the wide range of taxes that will continue to apply to the investment income earned by businesses with the increased savings and investment from the personal accounts. The President can also decide in his budget each year to devote more resources to the transition obtained by reducing the growth in other expenditures. Just reducing the rate of growth of other government expenditures by one percentage point each year would eliminate most of the transition deficit over time.

Any net remaining transition deficit each year after all these factors would be covered by issuing federal bonds in an off-budget account that would not be part of the rest of the federal operating budget. The bonds could then be retired over a period of 30 to 40 years. Over time, the net revenues from higher savings and investment and higher economic growth, and the savings to Social Security from workers relying on personal accounts should produce a net surplus from the reform that can be used to pay off these transition bonds. The off-budget account does not involve any new government spending or any new government debt.

The Benefits of Reform

Personal ownership and control and broader freedom of choice. Workers would personally and directly own the funds in their individual accounts, like their own personal bank accounts. They would enjoy freedom of choice over investment of those accounts in a wide range of professionally managed funds. They would also enjoy broader freedom of choice over retirement age, as workers could retire at any age after 59 1/2. Workers would be free to choose to leave substantial funds from their accounts to their children or other heirs. They would also each be free to choose to stay in the current Social Security system as is.

Higher returns. A conservative diversified portfolio of half stocks and half bonds would yield a real return of around 5 percent, after accounting for administrative costs. Even though under the reform proposal advanced here substantially less would be paid into the personal accounts than the tax payments required by Social Security, at standard market investment returns workers would get substantially more in benefits from the personal accounts than Social Security promises.

Social equity, and benefits for minorities. Low-income workers would receive similar gains under our progressive proposal. The poor deal offered by Social Security applies with a vengeance to African-Americans, because they have much lower life expectancies than the general population. Consequently, they tend to live fewer years in retirement to collect benefits, and more frequently die before reaching retirement age. Workers who die before retirement or just after retirement would be able to leave the account funds they had accumulated to their children or other heirs.

Hispanics also suffer from a special problem under Social Security. The Hispanic population is much younger than the general population, and since the return paid by Social Security is falling over time, younger populations get lower returns on average than others.

A social safety net. The personal account system would be backed up by a social safety net guaranteeing that workers with the accounts would get at least what they would have gotten from the old Social Security framework.

Broader and more equal ownership. Through these accounts, below-average-income workers would enjoy their only real chance to participate in capital markets like higher income workers and accumulate substantial savings and capital.

Greatest tax cut in world history. Under this reform proposal, the payments into the personal accounts would be about one-third less than the current taxes for Social Security retirement benefits. Eventually, as the transition costs are brought under control, the current tax would be reduced to the mandatory payments into the accounts, for those who exercise the account option. Such a reduction in payroll taxes amounts to a payroll tax cut of about one-third, shared equally between future workers and employers. The rest of the current payroll tax is transformed into private payments into personal, individual, investment accounts.

Greatest reduction in government debt in world history. Ultimately, we would reach the point where virtually all retirees are relying on personal accounts for their retirement benefits. At that point, the old Social Security framework would bear little or no benefit obligations, and there would consequently be no major deficit of any significance for that older system to cover. As a result, the personal accounts would have completely eliminated the unfunded liabilities of Social Security. Moreover, the net impact of the transition to personal accounts on the annual budget deficit is zero under this reform plan, because the transition is financed completely off-budget.

Conclusion

Personal accounts would restore what people originally thought Social Security was supposed to be: a means of saving for their retirement in their own designated account.

Some reformers are now urging President Bush to use his political capital to push through a package of substantial long-term benefit cuts, along with a small personal account of roughly 2 percentage points. But that may well be politically suicidal and not nearly achieve the true and full goals of reform. Instead, the President should use his substantial clout to push through a complete and progressive personal account reform as described here.

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This study is a summary of IPI Policy Report # 176, *A Progressive Proposal for Social Security Personal Accounts,* by Peter Ferrara.

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