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Summary: *Escalating federal spending presents a real and present danger to the fiscal health of the nation. The solution to bringing congressional budgeting back under control is personal retirement accounts. They would provide a built-in mechanism to control federal spending, pay off the national debt, eliminate the long-run unfunded liability of Social Security, keep the trust funds perpetually solvent, and boost economic growth.*

QUICK STUDY

Reducing Government Consumption, Increasing Personal Wealth

By Lawrence A. Hunter

The congressional budgeting process is so complex, so convoluted and so dysfunctional that not even most members of Congress know what is going on. The two characteristics of real budgeting are absent, namely binding budget constraints and enforceable spending priorities. Today, the stakes are enormous: congressional dalliance has become a real and present fiscal danger to the nation.

After falling below 18.5 percent of GDP and being on a downward trajectory, spending has risen back to 20 percent of GDP and is on an upward trajectory. Unless Congress takes action, the Congressional Budget Office (CBO) projects federal spending will increase by one fourth, consuming an additional 5 percent of GDP by 2030 and nearly a third of the nation's output at mid-century.

There is a solution: allowing workers to invest their Social Security contributions in personal retirement accounts and enacting a speed limit on the growth of federal spending to help cover the cost of redirecting payroll tax revenues into the personal accounts.

Much has been written about the financial security this would bring to America's workers during their retirement. While this is certainly true, personal accounts would result in another very important benefit: bringing fiscal discipline to the U.S. Congress.

Making Every Worker An Owner

No budget trend is inevitable, but all signs point toward larger, more encompassing government. The huge new Medicare prescription drug entitlement enacted last year suggests we are on a one-way path toward an American version of Euro-socialism.

It is not too late to avert a descent into that quagmire. Avoiding that fate will require a big idea, bold political leadership, and reconfigured incentives.

The big idea is to turn all American workers into owners of financial assets through instituting personal retirement accounts and paying for them, in part, by restraining the growth of government, i.e., curtailing public consumption so personal wealth can grow.

The Alliance for Retirement Prosperity (ARP), a coalition of some two-dozen advocacy groups co-chaired by Dick Army, Jack Kemp and former Social Security Commissioner Dorcas Hardy, has put forward the following four principles to guide the design of personal-account legislation:

1) **Make personal retirement accounts large enough — at least half the payroll tax (6.2 percentage points).** This would provide adequately for workers' retirement without the need for a permanent, supplemental tax-financed, government-benefits component, except to provide a safety net and initially to finance the disability component of the program.
2) **No future benefit cuts.**
3) **No tax increases.**
4) **Finance the transition to personal accounts through a combination of federal spending-growth restraint, federal borrowing and the increased tax revenues produced by tax reforms and the higher economic output that such accounts would produce.**

The only extant legislative proposal that meets these principles is the "Social Security Personal Savings and Prosperity Act of 2004" recently introduced by Congressman Paul Ryan (R-WS) and Senator John Sununu (R-NH), which in large part is patterned after the plan described in IPI Policy Report # 176 (henceforth called the Progressive Personal Accounts Plan or PPAP). The Chief Actuary of the Social Security Administration has scored the PPAP proposal as "actuarially sound." That assessment is based on the assumptions that federal spending is held about 1.5 percent of GDP below what it otherwise is projected to be, and that increased national saving will generate additional tax revenue, which will be earmarked to finance the transition from the current pay-as-you-go system.

According to the Chief Actuary's score, with these two legs of transition funding in place, the net transition deficits would average $52 billion (constant 2003 dollars) a year over the first 24 years. New public debt, including accrued interest, would rise by a total of $1.82 trillion (constant 2003 dollars), actually reducing the debt's share of GDP from 38 percent today to 29 percent. Sufficient surpluses would be produced after 2028 to pay off all the new borrowing within 15 years, leaving the net impact on debt held by the public at zero after less than 40 years.

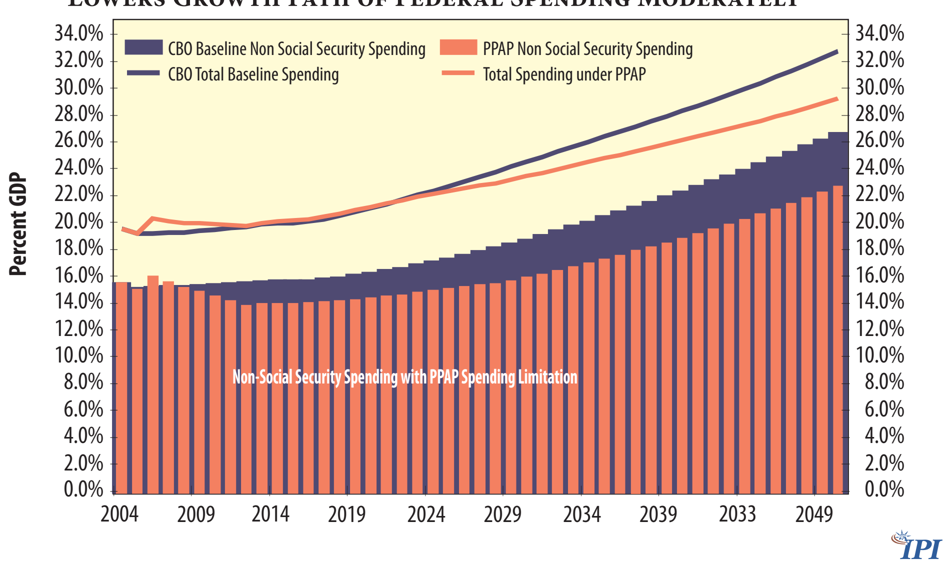
The status quo is unthinkable. Continuing Social Security as we know it would add $1.6 trillion (constant 2003 dollars) to federal debt held by the public by 2028. By mid-century, the national debt would exceed the nation's annual output. During the next quarter-century, annual deficits would approach 15 percent, and the national debt would skyrocket to 350 percent of GDP.

Creating a Powerful Constituency for Spending Restraint

Under the federal spending-limitation proposal contained in the Ryan/Sununu bill, Congress would be required to restrain annual spending growth to be one percentage point lower than it currently is projected (20 percent of GDP) for each of the next eight years. During the subsequent five years, spending growth would be permitted to match the annual growth rate of the economy, and thereafter federal spending could grow at the rate of annual economic growth plus 1.75 percentage points.

If Congress desired to exceed the spending-growth speed limit, it would have to vote by a two-thirds supermajority to do so, enact a tax increase and/or allow the deficit to rise. Therefore, for the first time, the rules would be stacked heavily in favor of spending-growth restraint. Moreover, every worker in America would have a powerful incentive to

Figure 1 Federal Spending-Growth Speed Limit Lowers Growth Path of Federal Spending Moderately



enforce the spending speed limit by pressuring Congress to keep spending growth within bounds because every dollar of reduced federal spending would go directly into their personal retirement accounts.

There also are stringent institutional rules in Ryan/Sununu bill to enforce the spending-growth speed limit. At the beginning of each fiscal year, transition funds would be appropriated automatically from the Treasury's General Fund into the Social Security Trust Fund for use in filling any revenue gaps created by redirecting half the payroll tax into personal retirement accounts.

A recurring critique of the proposal has been that Congress will never restrain federal spending growth sufficiently to maintain spending at 18.5 percent of GDP for any significant length of time. But under a spending-limitation provision such as the one contained in the Ryan/Sununu bill, with every dollar in federal spending restraint automatically being routed directly into personal retirement accounts, politicians will find it in their immediate political interests to finance personal accounts without raising taxes or cutting benefits.

Redefining the Challenge

The greatest threat to real Social Security reform comes not from a fearful or ignorant public but from inside-the-beltway, "demand-side fiscalists" in both political parties who insist that before such accounts are inaugurated, something must be done — i.e., raise taxes, cut benefits, raise the retirement age, increase taxation of benefits — to "make the program solvent."

By contrast, proponents of using the Social Security platform to create an investor nation define the challenge not as "fixing" Social Security or "making it solvent", but rather to transform it into a vehicle for making every worker an owner of assets.

Lowering the Growth Path of Federal Spending

The spending-growth-limitation provision scored by the Chief Actuary is far from draconian. By 2050, as illustrated in Figure 1, total federal spending (including transition funding) would still be 46 percent higher than today. Non-Social-Security spending (excluding transition funding) would still be 13 percent higher than today.

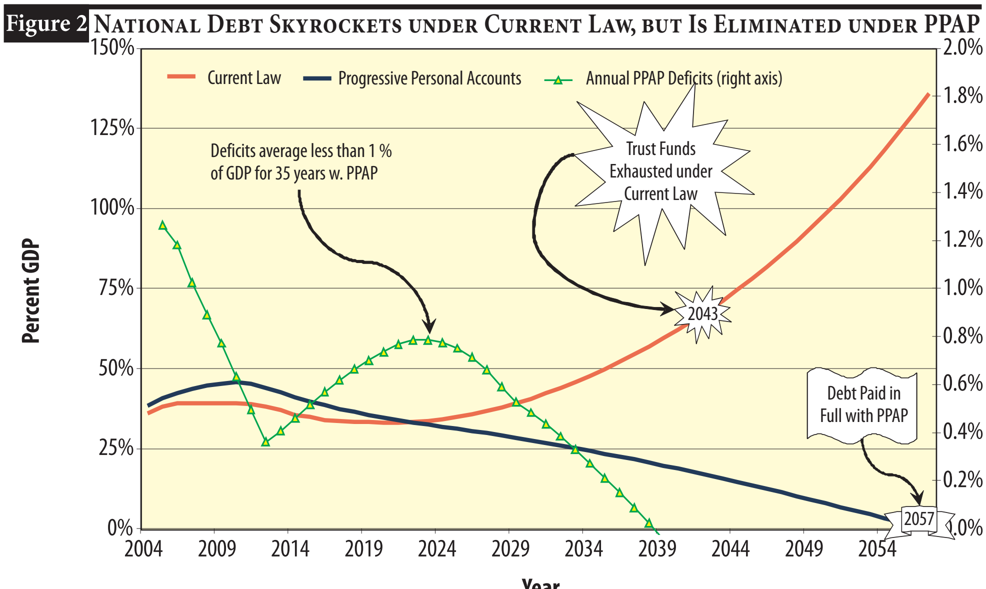
Moreover, during the deficit years of the transition period (2005-2039), the "dis-saving" occurring as a result of government borrowing to finance the transition to personal accounts would be more than offset by a decrease in government consumption produced by spending growth restraint, for a net increase in national savings of 5.7 percent. Over the long term, surpluses emerge and all of the transition debt is paid off so that the net decrease in government consumption is twice the amount of transition borrowing.

Retiring the National Debt

Figure 2 compares what would happen to the public debt under current law and what would happen to it with large progressive personal retirement accounts under the federal spending-growth speed limit, assuming revenue growth picks up as a consequence of lower public consumption and higher private saving and that all Social Security benefits promised under current law are paid in full without raising tax rates.

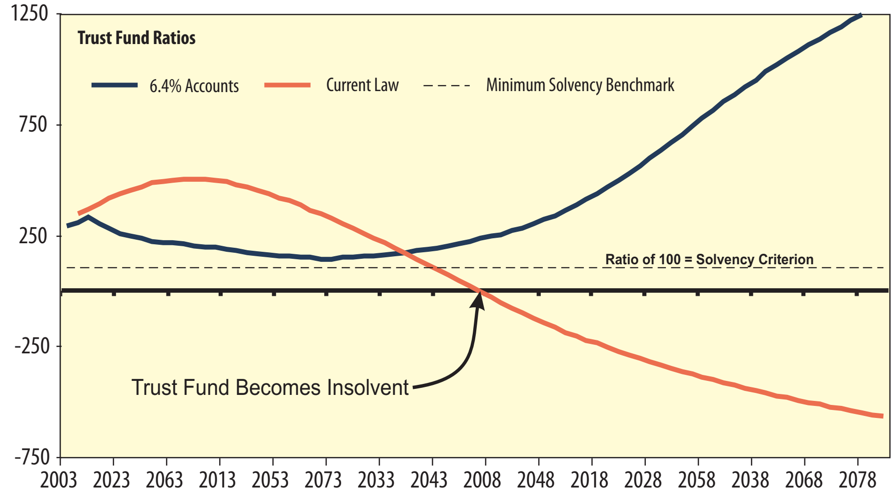
That comparison reveals that public debt, including accrued interest, rises by a total of $1.82 trillion (constant 2003 dollars) with large personal accounts. But the reform plan produces enough surpluses after 2028 to pay off all those bonds within the subsequent 15 years, leaving the net impact on debt held by the public at zero over the 40-year

Figure 2 National Debt Skyrockets under Current Law, but Is Eliminated under PPAP



Source: Office of the Chief Actuary of the Social Security Administration, Congressional Budget Office, and author's calculations

Figure 3 TRUST FUNDS REMAIN PERPETUALLY SOLVENT UNDER LARGE PROGRESSIVE PERSONAL ACCOUNT PLAN (PPAP)



time horizon. At no time would annual deficits exceed 1.5 percent of GDP, and they would average less than 1 percent most of the time.

Compare that with maintaining Social Security as we know it: by 2057, the insolvent system is projected to drive the national debt to more than 125 percent of GDP, whereas it would be paid off by then under PPAP.

Solvency in Perpetuity

Figure 3 illustrates the fact that as the Chief Actuary scored the PPAP, the Social Security trust funds would never fall below $1.38 trillion, or 145 percent of one year's expenditures (100 percent is the standard for solvency). After 2028, the trust funds would grow permanently, eventually reaching $6.3 trillion, or 12.5 times one year's expenditures.

By contrast, under current law, the Social Security trust funds would start a permanent decline in 2018, and would be exhausted by 2042.

In the unlikely event that economic output did not rise as anticipated or Congress failed to restrain spending growth as instructed, and voters chose to raise taxes or scale back personal accounts in order to reduce deficits, so be it. That choice, however, is a decision for the democratic process to work out in the fullness of time, not for policy wonks to pre-determine.

Conclusion

A system of personal retirement accounts designed along the lines of the Progressive Personal Accounts Plan, including a built-in mechanism to control federal spending as part of the transition financing, would deliver unprecedented benefits to Americans. Not only would congressional budgeting be brought back under control, but the system would provide generous retirement security for workers, eliminate the long-run unfunded liability of Social Security, keep the trust funds perpetually solvent, boost economic growth, and ultimately pay off the national debt.

Policy makers and concerned citizens would do well to examine its merits and advocate its implementation.

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