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Design Principles for Strengthening Social Security through personal accounts

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Social Security represents a commitment by the Federal Government to not only those currently receiving benefits, but also those paying Social Security payroll taxes. A major reason that Social Security today is in trouble is that the Federal Government has failed to acknowledge, quantify, and finance this commitment. But it is real, nonetheless.

Because it is a real commitment, the existing unfunded liability of the Social Security system should not be subject to evasion or default but rather must be treated as a financial obligation of the United States government every bit as binding as the debt held by the public.

According to the best estimates of the Social Security Trustees, the program as currently configured cannot deliver fully on its liability beyond 2017. Every year that passes between now and then without remedial action increases the magnitude of the financial problems.

But even if Social Security were able to fund its liability, the rate of return workers can expect to receive in benefits on the payroll taxes they pay—even if all promised benefits are paid in full—is woefully inadequate and substantially below the return they could expect if that same amount of money were invested in stocks and bonds or even in a bank account.

The problem with Social Security is not that promised benefits are too high, or that payroll taxes are too low. The problem is not the retirement age. The problem is not that Social Security promises too much. The problem is that Social Security delivers too little because payroll taxes have been spent on other unrelated government programs, rather than invested on behalf of the taxpayers for retirement.

A well designed system of voluntary personal retirement accounts can make Social Security permanently solvent and deliver demonstrably superior benefits to the vast majority of retirees as compared with the current Social Security system. At the same time, it would allow for increased flexibility in the age of retirement.

Because of the urgency of the problem, and because of the tremendous opportunity afforded American workers by personal accounts, Social Security's problems must not simply be pushed off into the future. Now is the time for a permanent solution based upon personal retirement accounts that workers own and control. With both Congress and the administration predisposed toward reform, this is an historic opportunity that must be seized.

But the debate is already being clouded by a smokescreen of false arguments from critics, and by a confusing array of options from reformers. In an attempt to bring clarity and guidance to the debate, the Institute for Policy Innovation (IPI) submits these Design Principles for Social Security reform.

Design Principles and Priorities

►Personal retirement accounts should be large enough so that once the transition period is completed workers will be able to pre-fund an adequate retirement from their personal retirement accounts without relying on any supplemental government retirement program.

The Office of the Chief Actuary of Social Security has already scored not one, but several proposals for reform with sufficiently large accounts to free retirees from their dependence on government transfer payments through Social Security.

►Any system of personal retirement accounts should include a guaranteed safety net that ensures workers they will receive at least as much as they are promised by Social Security currently.

All retirees, both current and future, should have the absolute assurance that any reform will at least leave them whole. This is critical to building a political consensus for reform, will defang opponents, and will insure that the Federal Government lives up to its commitments.

►**Cutting current or future benefits, altering the manner in which benefits or benefit increases are calculated or increasing the retirement age constitute default on the government's moral obligation to meet its financial obligations, which must be avoided.**

Tampering with benefits in any negative way (e.g., switching the method by which initial benefits are indexed from wages to prices) will undercut the political consensus and will inevitably reduce the replacement rate for Social Security. It makes Social Security less-secure, not more secure, and gives taxpayers a worse deal, not a better deal. In the U.K., where benefit formulas moved away from wage-based and toward price-based, the experience has been negative, and there is now a majority consensus that pensions must be re-indexed to wages.

►**Raising Social Security payroll taxes by increasing rates or lifting the income cap or raising other taxes to pay currently promised benefits or finance the personal retirement accounts must be avoided.**

Raising the cap on payroll taxes without some other tax offset constitutes a net tax increase, and should be rejected. And the net drag of a tax increase on the economy may more than offset any economic gains from personal accounts.

►**Possessed of a fully-funded personal retirement, all workers should be able to retire whenever they choose without regard to a pre-determined retirement age.**

The "Retirement Age" is a relic of a centralized, command-and-control approach to retirement. Workers should have control over how long they work and when they begin receiving benefits similar to the rules controlling IRA and 401k programs. There should be no punishment or reward for accelerating or delaying the onset of retirement benefits.

►**To ensure personal retirement accounts generate more than Social Security currently promises for even low-income workers, and to guarantee high levels of voluntary participation in the accounts, the contributions schedule must be "progressive," allowing a higher percentage of income to be saved at lower income levels.**

The current Social Security system has a very progressive benefits schedule. In order to guarantee that workers do at least as well under a reformed system as they do under the current system, a progressive contributions schedule is necessary. There should be no objection to allowing workers to contribute progressively more of their own money toward retirement.

►**There are no "transition costs."**

Recent Nobel laureate economists agree that, properly understood, there are no transition costs to moving to a pre-funded Social Security system. There is, instead, a short-term shortfall in payroll tax revenues which is more than offset by the future build-up in value of the personal accounts.

With tax increases and benefit reductions off the table, there are three desirable methods for obtaining the necessary additional cash flows to make up for the diversion of payroll taxes into personal accounts:

1. Budget savings from modest restraints in the overall growth in other federal spending should be earmarked to be paid into the Social Security Trust Fund.

The need for federal spending restraint is widely understood, and supported. What has lacked is linkage to a tangible benefit to taxpayers for such restraint. By dedicating the savings from federal spending restraint for personal accounts, policy makers will for the first time create a political constituency for spending restraint.

2. Revenue increases expected from higher long-run economic growth brought about by the personal accounts reform and by other tax reforms should be earmarked to be paid into the Social Security Trust Fund.

Appropriate tax reforms at both the individual and corporate levels will encourage the domestic investment of personal accounts, which will result in new (rather than replacement) saving. The investment of this new saving will result in higher overall economic growth, which will result in higher overall tax revenue.

3. The federal government should issue new bonds as necessary to redeem Social Security Trust Fund Bonds and to pay all promised Social Security benefits while earmarking future payroll-tax surpluses to repay this debt.

Whatever level of borrowing is necessary to complete the transition to personal accounts should be viewed as the costs of refinancing an existing obligation of the federal government. Converting an unacknowledged financial obligation into debt instruments recognized by markets is an improvement in the nation's financial situation, not a step in the wrong direction.

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