ISSUE BRIEF

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Social Security Reform and National Spending Restraint

by Stephen Moore and Peter Ferrara

Synopsis: The most desirable method of financing the transition to personal retirement accounts is to modestly reduce the growth rate of federal spending. Raising taxes would harm the economy. And future benefit cuts are wholly unnecessary, not only because they would do nothing to bridge the short-term financing gap, but also because the eventual proceeds from large personal accounts would more than offset any savings gained from cuts in promised benefits.

Allowing workers to shift payroll taxes to personal accounts creates a transition financing issue. But this is almost exclusively a political problem, not an economic one, because shifting to private accounts dramatically reduces long-term debt of the government, even though it increases debt in the short term.

The political problem of "transition costs" arises because of the pay-as-you-go financing of Social Security. The money that today's workers pay into Social Security is not saved or placed into a "lock box" to be invested for their future retirement. Instead, the dollars are immediately paid out to finance the benefits of current workers. Anything left over is spent on other government programs—from Department of Agriculture farm subsidies to Pentagon weapons systems. Under this financing system, which would be illegal for a private pension program, future benefits of today's workers are to be paid out of the future taxes of the next generation of workers.

If workers shift a portion of their payroll taxes to saving and investment in their own personal retirement accounts, those funds will not be available to finance currently promised benefits. Consequently, many personal account proposals provide for transition financing to ensure those benefits are paid in full, until the accounts themselves start paying the benefits to retirees.

The Spending Limitation Opportunity

Any proposal providing for large personal accounts big enough to solve the long-term problems of

Social Security, such as that contained in the bill introduced by Rep. Paul Ryan (R-WI) and Sen. John Sununu (R-NH), would require transition financing from several sources. The Ryan-Sununu bill relies on four such sources:

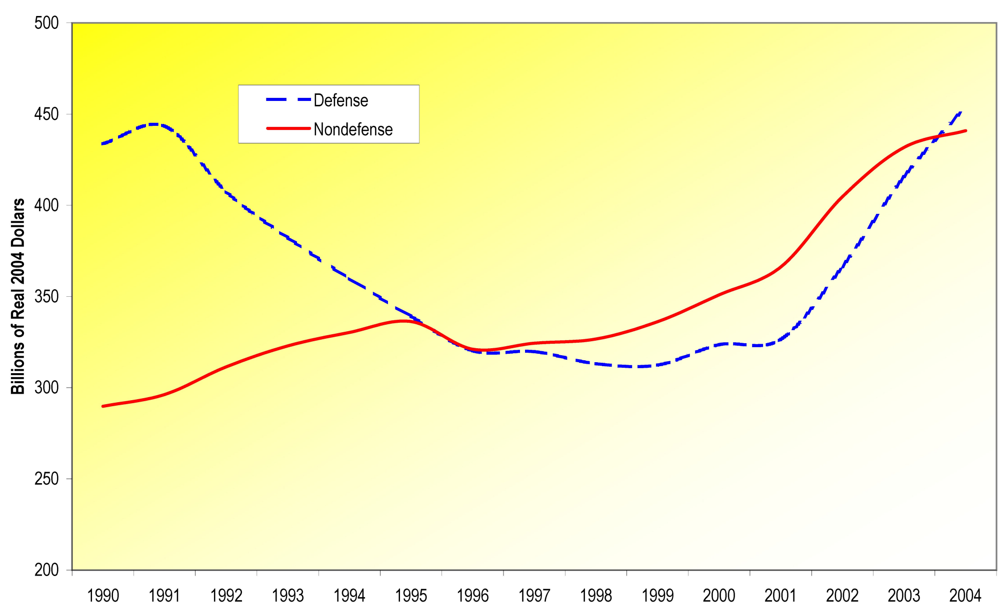
- Reserving the short-term Social Security surpluses projected until 2018 for the transition;
- Reducing the rate of growth of federal spending by 1 percentage point a year for eight years, through a new national spending limitation measure, and devoting those savings to the transition;
- Devoting to the transition the increased tax revenues that will result from businesses investing new funds obtained by selling stocks and bonds to the personal account holders;
- Short-term borrowing that would later be paid off in full out of the long-term surpluses generated by the reform.

This is a well-balanced package. But what needs to be emphasized is that reducing current levels of government spending is the most economically optimal method of financing the personal account transition. To the extent that the transition can be financed by eliminating wasteful or counter-productive federal expenditures, the plan creates added economic benefits: increased long-term savings through personal accounts; and reduced short-term consumption, by cuts in the growth of government expenditures, on items that tend to have a low rate of economic and social return. Many economic studies suggest that current levels of government spending (20 percent of GDP at the federal level and 33 percent of GDP at all levels of government) is a drag on the economy.

In recent years the federal budget has grown at an unusually rapid pace, with domestic spending in President Bush's first term increasing at about 7 percent per year, or almost three times the rate of inflation. In the past four years the budget has grown at a faster pace in inflation-adjusted terms than under any president since Lyndon Johnson launched the Great Society. Given this recent spending build-up, there are now opportunities to reduce wasteful spending in virtually every agency of government.

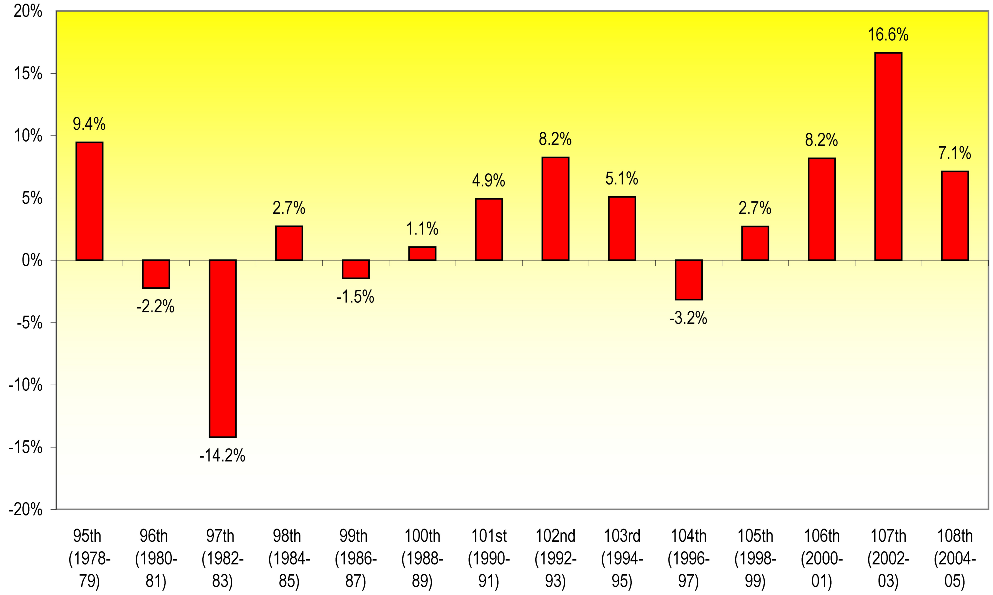
The U.S. Government Accountability Office (GAO) has found massive waste and fraud in

FIGURE 1 **GUNS AND BUTTER: DISCRETIONARY SPENDING EXPLODES**



Source: CBO, January 2005

Figure 2 **Real Percentage Change in Nondefense Spending by Congress**



Source: CBO, January 2005

federal programs. For example, Medicare has lost tens of billions of dollars due to billing fraud in recent years, the Department of Agriculture sends out billions of dollars a year in food stamps to ineligible households, and the Pentagon cannot even account for tens of billions of dollars that it receives in Congressional appropriations. Such reports confirm what most Americans suspect to be true: that the government wastes a fairly high percentage of the dollars that flow to Washington.

A modest spending cap could root out low-priority spending without requiring cutbacks in vital services, or payments to the truly needy, or reductions in expenditures in the war on terror.

The government does not even have to be "cut" in order to accrue hundreds of billions of dollars of budget savings over the next decade. The spending cap plan in the Ryan-Sununu legislation, for instance, only requires that the growth rate of the budget be *reduced*.

As such, financing part of the transition with a national spending limitation measure becomes a vehicle to help get federal spending under control. That makes such a measure both politically attractive and economically beneficial.

If we fail to consider the spending restraint option, then the transition financing might succumb to much less attractive alternatives. Chief among them are tax increases or cuts in future promised Social Security benefits. Raising taxes—especially increasing the payroll tax—is the worst financing idea because payroll taxes reduce employment, work effort and national output. The payroll tax is already a major contributor to unemployment in the United States, and any further hikes would exacerbate the jobs shortage. Furthermore, this is a non-option at least until 2009, because President Bush has ruled tax increases off the table.

Proposing to cut future promised Social Security benefits is politically risky because opponents will argue that this is part of a secret plan to "dismantle Social Security." The focus of the Social Security debate would shift from personal accounts and all their attendant benefits to a diversionary debate over the wisdom of benefit cuts to eliminate long-term Social Security financing gaps.

In reality, personal accounts are the *antidote* to future benefit cuts. If we do not move aggressively toward a personal investment account system, the alternative is to sharply reduce promised benefits in the future.

Future benefit reductions, moreover, would do nothing to bridge the short-term financing problems associated with the creation of personal retirement accounts. The best way to finance the transition to such accounts is to save money in the budget *now*, because now is when the budget shortfall is most severe. There is little advantage to benefit cuts that don't affect the budget outlook significantly for another 20 or 30 years, because by then, the private accounts start to pay for themselves. This suggests that to bridge the current transition costs so that government borrowing is minimized, *current* Social Security benefits would have to be cut. Not only would that be unfair to today's retirees, but almost no politician seeking reelection would ever dare vote for such a proposal.

> *Future benefit reductions, moreover, would do nothing to bridge the short-term financing problems associated with the creation of personal retirement accounts.*

Additionally, with large personal accounts such as those promised in Ryan-Sununu, cutting future promised Social Security benefits is not only completely unnecessary, but ultimately ineffective in achieving additional savings. This is because large accounts shift so much of the Social Security benefit obligations to the accounts, more than offsetting any savings gained from cuts in the remaining benefits under the old system.

For example, a worker retiring in 2040 may be promised $1,300 in monthly Social Security benefits in today's dollars under current law. Under a large personal account plan, by contrast, he may receive, say, $300 per month through the old Social Security system, with the remaining $1,000 more than replaced by benefits paid through the personal account. Any proportional cuts in the $300 still paid through the old system would not yield much in savings. By 2050, a worker who has contributed to a personal account for his entire career may no longer receive any retirement benefits from the old Social Security system. He or she would be enjoying much higher benefits through the personal account than those promised by Social Security.

Therefore, cutting the Social Security benefits promised to this worker would yield no savings to the government, because those promised benefits would be entirely displaced by the better benefits paid through the personal account. Any politician advocating a future benefit cut would suffer heavy political costs all for naught, since there would be little or nothing in savings.

Table A illustrates this. It shows the percentage reduction in Social Security retirement benefit expenditures that the federal government would enjoy each year under Ryan-Sununu, as workers receive the benefits through personal accounts instead of under the current system. The government's Social Security retirement benefit liabilities would be reduced by 40 percent by 2040, 67 percent by 2050, 80 percent by 2056, and 95 percent by 2078. With these liabilities shifting to the personal accounts so rapidly, there is little or nothing to be gained by attempting to cut future promised Social Security benefits—certainly nothing worth the huge political costs of enacting such cuts.

In sum, one of the advantages of large personal accounts is precisely that they allow us to avoid this counterproductive debate entirely. The accounts themselves eventually eliminate long-term Social Security deficits by tapping into the magical power of compound interest, and by shifting so much of the long-term Social Security benefit obligations to the accounts.

Another proposed option is to fund the entire transition through long-term borrowing. We would not be opposed to this. Borrowing would simply acknowledge today the current system's huge unfunded liability costs of the future. Future generations would pay off bridge-financing debt incurred in order to provide them with a modernized Social Security system with high returns. We believe that future taxpayers would wholeheartedly prefer that deal over the alternative, i.e. being forced to shoulder the massive financial burden of a bankrupt pension program.

There are, however, two reasons why cutting spending now is preferable to 100 percent borrowing. First, the federal deficit is currently some $400 billion, and it is not clear whether the public will easily accept a $200 billion-a-year increase in government borrowing, even if the borrowing were to be paid off over 40 years from a dedicated revenue stream. Second, government spending is too high already, and it makes sense to dedicate the budget savings from a federal spending restraint mechanism to help pay the short-term costs of erecting a high-return, modern Social Security system for our children and grandchildren.

Federal spending restraint would increase the growth potential of the economy by increasing the national savings rate.

The Ryan-Sununu Spending Restraint

The Ryan-Sununu bill recognizes these points and fully develops the spending restraint option. It reorients the federal budget process to enforcement of the restraint. A two-thirds vote of each house of Congress is required to exceed the restraint. The budget process in each house is subject to a point of order objection to stop any violation of the restraint.

Moreover, the amount of spending limitation in the bill is very modest and quite achievable. Over the initial eight-year period, it would limit federal spending to grow each year no more than its long-term baseline of the rate of growth of GDP, minus 1 percent. Consequently, during that period, federal spending as a percent of GDP would decline from 20 percent to 18.4 percent. The bill would then allow federal spending to continue to grow at the old baseline rate, keeping spending only 1.6 percent of GDP below that baseline. (Of course, after eight years, we would be very much in favor of extending the spending limit, but that decision would be left up to future Congresses.) Once the transition to personal accounts is financed and all short-term debt issued during that transition is paid off, the spending limitation in Ryan-Sununu is eliminated. But if spending growth thereafter is just held to the rate of economic growth, the baseline level of spending would be permanently ratcheted downward, and thus the budget savings would continue year after year.

The spending restraint during the first eight years is even more modest than that achieved during the eight years of the Clinton administration, which held federal spending growth to the rate of growth of GDP minus 1.8 percentage points each year. (Of course, the Republican Congress was a primary factor in that achievement.)

For those who believe that this kind of fiscal restraint would hurt the economy, we would note that the growth rate of the economy from 1994 to 2000, when the federal spending rate fell dramatically, was 4.5 percent in real terms. Federal spending restraint would increase the growth potential of the economy by increasing the national savings rate.

Moreover, the restraint during the first eight years is exactly the amount of restraint we need to achieve if we are going to balance the federal budget while keeping the Bush tax cuts permanent, as shown in a recent study by Dr. Lawrence Hunter.[1] The Bush tax cuts would leave federal revenues over the long run at about 18.4 percent of GDP as well.

Both the Cato Institute and the Heritage Foundation have published extensive material documenting far more in wasteful and counterproductive spending than would be needed to achieve the spending limitation targeted in Ryan-Sununu.[2] Earlier this year, IPI published a study by this paper's co-author Stephen Moore also proposing far more in desirable spending restraint initiatives.[3] The spending restraint measure in the bill is not limited to domestic discretionary spending, or even to all of discretionary spending. All federal spending outside of Social Security is eligible for restraint to help meet the target. Any and all other entitlement programs can be reformed to meet the target. Corporate welfare can be cut or eliminated. International treaty obligations increasingly seem to require reductions in agriculture subsidies. Even the military budget is not off limits. Unneeded military bases, for example, can be shut down.

Spending restraint is at least as manageable and reliable as the alternatives, perhaps more so, for several reasons.

The Ryan-Sununu spending restraint mechanism does not tell Congress *how* to cut the growth rate of spending, it simply requires Congress to set expenditure priorities. Low priorities would get appropriately squeezed out of the federal budget.

Over the long run, the bill's modest spending restraint would indeed allow federal spending to grow by more than 50 percent relative to GDP, from 18.4 percent of GDP to well over 30 percent—a huge increase already slated to occur under current law that we must avoid. So the Ryan-Sununu spending restraint is, in fact, just a relatively small first step. Over the long run, we need far stricter spending restraint. We should, in fact, target the 18.4 percent of GDP that the bill would establish after the first eight years as a long-term restraint target. That, however, would require thorough reform of other entitlement programs, and all other areas of federal spending. But that is much more than is required for the transition to large personal accounts under Ryan-Sununu.

Is It Enforceable?

Any future Congress could change the Ryan-Sununu spending limits and choose to spend more. One Congress cannot bind future Congresses, it is said. But that is true of any means of financing the long-term transition to personal accounts.

Rather than spending limits, suppose the transition were financed by a tax increase. A future Republican presidential candidate could campaign on tax cuts and, upon election, reverse the tax increase intended to finance the transition.

Suppose the transition were financed by a reduction in promised Social Security benefits. A future Democratic presidential candidate could campaign on reversing those cuts and restoring the future level of promised benefits. Again, one Congress cannot bind a future Congress on any of these alternatives. Future Congresses may, in fact, want to change how they finance the transition over time.

But the spending restraint, in addition to being the most desirable of alternatives as discussed above, is at least as manageable and reliable as the alternatives, and perhaps more so, for several reasons.

First, the national spending limitation provisions in the Ryan-Sununu bill cannot be easily dismissed. Again, they reorient the whole federal budget process around the spending limitation, and require a stiff two-thirds majority of both houses of Congress to get around it. Budgetary procedures are changed to allow any member of Congress to halt a spending initiative inconsistent with the spending targets.

Moreover, general federal spending restraint enjoys broad public support. Many voters today believe federal spending has been growing far too fast, and would think the Ryan-Sununu spending restraints are far too modest for general budget needs. With these public attitudes, the Ryan-Sununu spending restraint could not be easily dismissed.

Second, the Ryan-Sununu bill would powerfully restrain federal spending simply by taking money off of the table for Congress to spend. With the money going into personal accounts, and the unavoidable mandate to pay all promised Social Security benefits to retirees[4], Congress will be forced to spend less than it would otherwise. As Milton Friedman has long argued, the best way to restrain the federal government's spending is just to reduce what is available for Congress to spend. The Ryan-Sununu bill does that, and so is a powerful aid in achieving future spending restraint. Congress cannot run future deficits beyond politically acceptable limits, and there are powerful political forces that work to restrain deficits and reduce the duration of deficits over the long run. These forces would further help enforce the Ryan-Sununu spending limits.

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Finally, the Ryan-Sununu bill changes the political dynamics of federal spending. Basic public choice analysis shows that the beneficiaries of federal largesse have a concentrated interest in maintaining and expanding their particular share of the federal spending pie. But the general public does not have enough of an interest in any one spending program to provide the resources to overcome the special interests benefiting from it.

That fully explains the stubbornness of corporate welfare, for example. XYZ corporation can have enough direct financial interest in a multibillion-dollar federal subsidy program to hire legions of lobbyists and publicists to promote its cause. But individual members of the general public do not have enough of a financial stake in that one program to provide the resources to counter the predatory corporate welfare boondoggle.

This is why federal spending restraint ultimately can only be achieved by a general federal spending restraint as in Ryan-Sununu. Individual members of the public have sufficient stake in such a general restraint to get involved in providing the necessary political support to adopt and enforce it. Ryan-Sununu adds to this by tying the spending restraint to a very popular large personal account option for Social Security. That greatly increases the likelihood that such a restraint can be adopted, and that it will be maintained over time. Indeed, under the bill workers enjoy every dollar of spending restraint, with that money effectively going into their direct personal accounts.

Conclusion

General federal spending restraint is the most desirable means of financing the transition to personal accounts. The Ryan-Sununu bill provides a well-designed and quite viable proposal for utilizing this option. But any personal account proposal can and should include such spending restraint to help finance the transition.

Table A — Percent of Annual Social Security Retirement Benefit Expenditures Shifted to Personal Accounts Under Ryan/Sununu

2004	0%	2029	18.9%	2054	76.4%
2005	0%	2030	20.7%	2055	78.4%
2006	0%	2031	22.4%	2056	80.2%
2007	0%	2032	24.2%	2057	81.9%
2008	0%	2033	26%	2058	83.4%
2009	0%	2034	27.9%	2059	84.7%
2010	0%	2035	29.8%	2060	85.9%
2011	0%	2036	31.7%	2061	86.9%
2012	0%	2037	33.3%	2062	87.9%
2013	0%	2038	35.3%	2063	88.7%
2014	0.5%	2039	37.8%	2064	89.5%
2015	1%	2040	39.9%	2065	90.2%
2016	1.5%	2041	42.1%	2066	90.8%
2017	2.2%	2042	44.3%	2067	91.3%
2018	3.2%	2043	46.7%	2068	91.8%
2019	4.3%	2044	49%	2069	92.2%
2020	5.4%	2045	54%	2070	92.7%
2021	6.7%	2046	56.6%	2071	93%
2022	8.1%	2047	59.3%	2072	93.4%
2023	9.5%	2048	61.9%	2073	93.8%
2024	10.9%	2049	64.5%	2074	94%
2025	12.4%	2050	67.1%	2075	94.3%
2026	13.9%	2051	69.4%	2076	94.5%
2027	15.5%	2052	72.1%	2077	94.6%
2028	17.2%	2053	74.3%	2078	94.8%

Source: Calculated from 2004 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds, March 23, 2004; Estimated Financial Effects of the Social Security Personal Savings and Prosperity Act of 2004, July 19, 2004, Office of the Chief Actuary, Social Security Administration.

Endnotes

1. Lawrence Hunter, "Reducing Government Consumption, Increasing Personal Wealth: Limiting Federal Spending Growth Through Large Personal Retirement Accounts," IPI Policy Report 183, July 14, 2004. The study assumed as well that the alternative minimum tax is fixed so it applies only to the highest-income taxpayers as originally intended, and not to the middle class.
2. See, e.g., Chris Edwards, Downsizing the Federal Government, Cato Policy Analysis No. 515, June 2, 2004.
3. Stephen Moore, "Putting Taxpayers First: A Federal Budget Plan to Benefit the Next Generation of American Taxpayers," IPI Policy Report No. 174, February 17, 2004.
4. The Ryan-Sununu bill ensures that Social Security will be taken care of in any event and all promised benefits to current retirees would continue to be paid. The bill provides that the federal government would transfer general revenues to Social Security each year equal to the amount of annual spending restraint provided in the bill, regardless of what Congress actually does in regard to spending. It is then up to Congress to implement the spending restraint, find the money elsewhere, or choose to run larger general deficits.

About the Authors

Stephen Moore is a senior research fellow with the Institute for Policy Innovation and a senior fellow at Cato Institute. He is also the founder of Free Enterprise Partners, a free market advocacy group.

Peter Ferrara is a senior research fellow with the Institute for Policy Innovation and director of the Social Security Project for the Free Enterprise Fund.

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

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