

# IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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**Hearing on Protecting and Strengthening Social Security**

**House Ways and Means Committee  
Subcommittee on Social Security  
June 21, 2005**

Congress has been asked to deal with the projected outyear deficits in the Social Security Old Age and Survivors Insurance program (OASI), and to help future generations better meet their retirement needs. It would be wise to take action now, while policy changes would have time to work, rather than wait until a crisis forces less benign choices on a future Congress. Before taking action, however, the Subcommittee needs to be clear about several things. What are the problems that you are trying to address? What policy options are available and what do they do? How can they be matched to the objectives?

**What are the problems that you are trying to address?**

Is your objective merely to deal with Congressional concerns about the Federal budget consequences of the OASI deficits? Is it merely to keep OASI solvent, more or less in its current form, for some period of time after the retirement of the baby boom generation, with minimal political fall-out? If these are the goals, Congress must either raise taxes dedicated to OASI, raise other taxes, trim OASI benefits, or trim other spending. There are an infinite number of ways to do this. Some combination of changes must be selected. In 1983, a compromise was agreed to under the cover of the Greenspan Commission. It merely bought time. It did not solve the System's long run problems, and paid no attention to the proposal's effects on the economy and the well-being of the population.

Are there additional objectives this time around? Should the solution enhance the retirement income of future generations? Should it improve the functioning of the economy? Should it give people more freedom and responsibility for their own welfare? Should it provide a permanent fix, throughout the 75 year planning period and beyond, rather than a temporary one as with the 1977 and 1983 Amendments? If so, you must address the solvency and budget issues in certain ways and not others, and go beyond solvency to address these other issues. In doing so, be very careful how you design your program to make it effective, affordable, and devoid of unintended consequences.

The interests of the public go beyond the narrow concerns of the Congress in these matters. Over the years, this Subcommittee has tried to study and address these more fundamental interests. Members of both parties have offered thoughtful and effective proposals. The Subcommittee's recent attention to the problem is most encouraging.

### **Hybrid nature of Social Security: a sound safety net, a shaky retirement system**

Social Security combines a social safety net program and a retirement income program. The social safety net includes insurance features, such as disability and survivors' benefits, and income transfers to low income earners. The original purpose of Social Security was to prevent poverty among the elderly, a stark problem in Depression-era America.

To attract political support for what was then a revolutionary national welfare arrangement, President Roosevelt and Congress extended retirement benefits to most workers, not just to the needy. The immature system, with many workers and few retirees, could offer middle and upper income workers a good return on their contributions to gain support for the safety net system. The retirement benefits were to be only one leg of a three-legged retirement income program, however. The other two legs were pensions and private saving.

Today, the system is mature. A full complement of retirees is drawing benefits, and the recipients are living longer than ever before. The birth rate is down, and there are fewer workers per retiree. Today, the Social Security system remains an effective anti-poverty program and safety net. As a retirement program, however, it is now a bad deal, and getting worse. Today, the carrot for younger workers to support the safety net is to allow them to buy their way out of the retirement system, rather than to remain in it, and to put some of their tax money into real saving vehicles that offer a much higher rate of return.

Social Security is a pay-as-you-go tax-transfer system, in both its safety net and retirement features. Income is payment for production. When a transfer system shifts income from taxpayers to beneficiaries, it is effectively taking output from those who produced it and giving it to others. A real retirement system, by contrast, involves real saving. It is funded, not pay-as-you-go. People devote some of their current earnings to saving. They consume less than they produce, and support capital formation, boosting productive capacity. The capital adds to future output, and when the savers retire, they are still producing goods and services via the capital they own. Their income is not a transfer from others, it is payment for additional output they are currently making happen. Substituting Social Security benefits for real saving has depressed capital formation (or made it more dependent on foreign saving), and has retarded productivity, wages, and GDP for decades. If done correctly, switching back to a system of real saving would boost capital formation and Americans' ownership of capital. It would boost productivity and wages too.

### **Role of government in retirement saving decisions today**

Why are we making a federal case out of retirement saving? What reason is there for the federal government to concern itself with the saving and retirement decisions of individuals? The usual justification is a concern over moral hazard. Society will not stand by and let people suffer extreme poverty in old age. But society does not want people to take advantage of that fact, and does not want to

pay for people who could have taken care of themselves. Thus, the government feels it has a right to force people to save when young to avoid needing assistance when old, and perhaps to make them buy an annuity so they won't fritter away the money or outlive it when they retire. This is a rather paternalistic attitude, piling one intervention (mandated saving) on top of another (the safety net). If this is the case for Federal involvement, the mandate should only extend to achieving the socially acceptable minimum level of retirement income. The government should not require people to do more, nor should it coopt other forms of saving.

### **How much saving should we mandate?**

Mae West once said, "Too much of a good thing is wonderful." But she wasn't talking about retirement saving, or Federal intervention in personal finances.

The program should let people stop adding to the government mandated accounts when they are big enough to provide whatever basic level of lifetime income the Congress chooses to set. Once an account holder is able to buy a minimum required annuity, or can fund a staged payout over his or her remaining life expectancy, that should be enough. The plan should then allow people to use the payroll tax diversion for anything they wish, i.e. an unfettered tax cut. (This feature is in the Chilean plan.) The plan should not make people contribute up to a specified retirement age no matter how large the accounts get.

Most plans only require individuals to annuitize a basic level of benefits, and leave them free to allocate the rest of their assets as they like, and that is good. But there is no public purpose served by forcing people to accumulate excessive funds in the government program in the first place. Let people use pensions, IRAs, and other saving plans for such purposes. Do not nationalize the retirement savings industry. Give people their freedom once they have met their mandated retirement needs.

### **How big a carve-out is needed? Should it be invested in high- or low-yielding assets?**

Carve-outs should be large enough, and accounts should earn enough, to allow people to replace all their Social Security retirement benefits. They should not be so large as to make transition financing unnecessarily difficult or to displace private pensions or IRAs.

*Some plans are too small.* Some plans recommend small carve-outs to minimize the apparent transition cost to the Federal budget. Some would make available low-yield investment options consisting mainly of government or corporate bonds. Such plans may be convenient for budget makers, and may satisfy people with a profound distrust of financial markets, but they do a disservice to the people.

Locking people into low-yielding assets as they work and save, and into low-yielding retirement annuities, would guarantee them a heavy saving burden when young and a low income when old. Their personal accounts might then deliver less than currently promised benefits, or even the reduced benefits that a trimmed down OASI system might offer. Their personal accounts would offset only a part of their Social Security retirement benefit, leaving a residual burden on the OASI system. For example, the relatively small carve-outs and the contribution caps in the President's Panel plan 2 and the Graham plan, and presumed investment guidance, could keep the accounts from matching current benefit levels for many people. The carve-out should be large enough, and the investment options should be high-enough yielding,

to generate a fund at retirement that can replace fully whatever retirement benefit would be available by remaining in Social Security. If Congress decides to trim the growth of future Social Security benefits for those who choose to remain dependent on the Social Security system, a lower carve-out would be needed to make the personal accounts more attractive than Social Security benefits.

***Some plans are too big.*** Some plans propose large carve-outs to match the benefits and replacement rates given to low income workers, who receive higher replacement rates than higher earners under OASI. For example, the Ryan/Sununu plan has an average carve-out of 6.4%, and, in a blended stock-bond fund, could match low income benefits currently promised. Another plan would let people put all 12.4% of the OASDI tax aside, including the Disability Insurance portion. Such carve-outs would over-shoot benefits and replacement rates currently promised to average and higher income workers, and far over-shoot what Social Security can pay at current tax rates, unless people could stop contributing to them once enough saving to generate a socially mandated basic retirement income floor was attained. (See tables 2, 3, and 4, below. Multiply the carve-out rates in the various plans by the potential replacement rates each percent of income saved could generate, and compare the results to what Social Security is promising.)

Furthermore, the accounts are assumed to be invested in fairly conservative blended funds before retirement, and low-yielding bonds afterwards. Such large carve-outs, if invested more in stocks, and in balanced annuities, would yield much larger retirement benefits. Replacement rates could reach 80 percent to 100 percent of pre-retirement income, and could coopt pensions, IRAs, and other private saving arrangements. We should not be proposing to take over the bulk of retirement saving in the revised Federal program. Too large a carve-out would also increase the transitional borrowing requirement or the amount of spending restraint needed to avoid the borrowing.

***Just right?*** An average four percentage point carve-out, designed to be higher for low income workers, and lower for high income workers, should be more than sufficient to induce most people to use personal accounts, especially if benefit growth is trimmed to avoid payroll tax increases, and if stock investments are encouraged. (See Table 4, Alternative plan.)

### **Should promised benefit growth be trimmed?**

If Congress makes the carve-outs and the resulting personal accounts so big that they will exceed everyone's promised Social Security benefits, and everyone will opt for them in lieu of benefits, it does not matter whether the regular benefits are trimmed or not. However, failure to trim benefit growth would make it harder for the personal accounts to beat what Social Security is promising, and less likely that people will switch. Bigger carve-outs would be needed, with a bigger explicit transition cost for the federal budget. That is something of an illusion, since we are shedding a corresponding Social Security promise (cutting the current unfunded obligation by \$10.5 trillion at a cost of \$2 trillion to \$4 trillion). Still, it is less costly to trim the program back to what current taxes can now pay for. Furthermore, trimming benefits would reduce government intervention in the saving decision. Smaller benefits would mean that more people would get all their system-related income from individual accounts instead of SSA.

The attached table VI.F10 from the Social Security 2005 OASDI Trustees Report shows the projected growth in real retirement benefits under current law. These numbers are after inflation. Wage indexing of the benefit formula, coupled with a projected increase of 128% in real wages by 2080, will send real

benefits soaring in line with wage growth. Add fifty percent for married couples getting a spousal benefit, and double the numbers for two worker couples each earning at the illustrative levels. Upper income couples could be getting over \$109,000 a year, in today's dollars. To meet these benefits, the payroll tax would have to rise by six percentage points, a major blow to low income workers. Surely, some trimming of benefit growth could be done without injuring future cohorts.

### **If we are to trim benefits, how should we do it?**

*Price versus wage indexing.* The 1972 Social Security Act Amendments included an automatic mechanism that over-adjusted benefits for inflation, and replacement rates soared. Prior to the 1976 election and the 1977 Amendments, a panel headed by actuary William C. Hsiao addressed the error. Unions, SSA, and HEW recommended wage indexing worker's earnings histories and the "bend points" of a new benefit formula, keeping benefits growing with wages over time. The Hsiao panel and OMB recommended using a price index for those elements to keep the system solvent over time. The resulting benefits would still have risen in real terms, just not as fast as with wage indexing. (See the Report of the Consultant Panel on Social Security to the Congressional Research Service, Prepared for the Use of the Committee on Finance of the U.S. Senate and the Committee on Ways and Means of the U.S. House of Representatives, 94th Congress, 2nd session, August, 1976.) In an election year, President Ford opted for the more generous wage indexing. He lost the election anyway.

This old form of price indexing the benefit formula differs from the current proposals for price indexing benefits in the President's Panel plan 2 and the Graham plan. The new proposals would hold benefit growth to the rate of inflation, starting in 2009. (It would keep wage indexing earnings and bend points, but lower the replacement factors in each bend point to offset inflation.) Cohort over cohort, future average wage workers would get the same real benefit as today's average wage worker; future low wage workers would get the same real benefit as today's low wage worker, and so on across all earnings levels.

A progressive price indexing plan has been suggested by Professor Robert Pozen. Benefits for the bottom 30% of the earnings distribution would be calculated as under current wage indexing. Benefits for the highest earners would be limited to price increases (as in this new form of price indexing). Benefits for workers between the 30th percentile and the top would be gradually scaled from the wage-indexed level to the price indexed level.

In 1994, Ways and Means Chairman Dan Rostenkowski and Social Security Subcommittee Chairman J. J. Pickle introduced measures to eliminate projected Social Security deficits. The Rostenkowski bill (H.R. 4245) slowed benefit growth for workers with average income and above by adding an additional bend point with a 10% replacement factor, and holding the growth of the top two bend points to a percent below wage growth for 50 years. The results roughly resemble the Pozen plan. The Pickle bill (H.R. 4275) gradually raised the normal retirement age to 70, which is another way to trim benefit growth. Other proposals would "index" normal retirement age to rising life expectancy.

### **To annuitize or not to annuitize, another key question**

Too much of an annuity is a bad deal for retirees. One cannot leave an ordinary annuity to one's heirs; payments die with the recipient. Annuities can be designed to cover more than one beneficiary, or

to guarantee a minimum return if the annuitant dies early, but such arrangements are expensive and complex. People should have alternatives, such as a paced withdrawal in line with life expectancy. If Congress insists on annuities, once a minimal anti-poverty annuity is purchased, a person should be free to use the rest of the account's assets as he or she wishes. But then, why make people accumulate that excess in the government sponsored plan in the first place?

### **Economic benefits demand careful design**

*Do not cap the carve-out.* The most certain economic benefit from diverting a portion of the payroll tax to personal accounts will come from the added incentive to work and hire. For that to occur, however, the incentive must exist "at the margin," i.e., extend to the next dollar one might earn by working longer or harder. To that end, the carve-out must not be capped. The President's Panel plan and the Graham plan only reduce the effective payroll tax rate at the margin on incomes up to \$25,000 and \$32,500, and give no incentive to people with higher incomes. The Ryan-Sununu plan reduces the tax rate and extends the work incentives all the way up to the maximum covered wage of \$90,000.

### **How the transition is funded will affect the economic outcome.**

Trimming government spending growth would free real resources to expand the private sector of the economy, funded by increased private saving. Borrowing would not free real resources, and would take back much of the saving in the personal accounts to pay for government operations. It would leave the economy slightly worse off over time. Raising other taxes, especially on capital, at the margin, would weaken the economy and reduce investment, employment and wages. For a more extensive discussion, see my testimony to the House Budget Committee Social Security Task Force, May 18, 1999. The attached Chart 1, adapted from that testimony, shows the impact of the various financing options on GNP.

### **To maximize gains in a global market, combine with tax reform**

One cannot assume that simply establishing personal accounts will boost growth and tax revenues by increasing national saving and investment. Some of the saving will displace other saving that people are already doing. Some of the saving may be borrowed by the government. Some of the saving will back out some of the saving flowing in from abroad, or will flow abroad. Businesses that borrow the saving may be fully invested in the United States under current tax and regulatory regimes, and may expand abroad instead.

To ensure that the personal accounts increase U.S. saving, investment, wages, employment, and output, Congress should: trim spending instead of borrowing to fund the transition; accord the accounts the same tax incentives given to pensions and IRAs; improve the tax treatment of investment by moving toward expensing of investment outlays and by extending the relief from the double taxation of corporate income provided by the 15% tax rates on capital gains and dividends. In short, Social Security reform and fundamental tax reform work hand in glove. Each reinforces the other. Chart 2, adapted from my Task Force testimony, shows the impact of adopting expensing as well as personal accounts. The resulting increase in GNP is substantially larger than without adding that feature.

**Some tables to guide the design of a proposal**

Table 1 lists historical rates of return on various assets that could be included in investment options for personal accounts. Compare these to the 2% return in OASI, which is the sum of population growth and productivity/real wage growth. Table 2 presents mixes of assets that would result in various rates of return. It also shows how much retirement income could be replaced, for each percent of income saved while working over a 45 year period, if invested in these mixed funds. Table 3, top section, shows the replacement rates that Social Security is promising to people at various levels of income, and how much it can actually deliver at current tax rates. The bottom section shows how much of a carve-out would be needed to match the Social Security replacement rates in personal accounts, at the various rates of return. Table 4 shows the carve-outs contained in various Congressional proposals.

<b>Table 1: Average Annualized Returns on Assets, 1926-2004 (Ibbotson Associates)</b>		
	nominal	real
Large company stocks	10.4%	7.2%
Small company stocks	12.7%	9.4%
Long term corp. bonds	5.9%	2.8%
Long term govt. bonds	5.4%	2.3%
Intermediate term govt. bonds	5.4%	2.3%
U.S. Treasury bills	3.7%	0.7%
Inflation	3.0%	n.a.

<b>Table 2: Returns on various portfolios of assets, and replacement rates for each % of income saved.</b>					
Portfolio mix, %stocks/%bonds*	0/100	40/60	60/40	75/25	95/5
Approximate real return during accumulation	2.5	4.5%	5.5%	6.5%	7.5%
Payout as % of pre-retirement income (replacement rate), annuity in bonds (real return of 2.5%), for each % of income saved*	4.0%	6.5%	8.6%	11.3%	15.0%
Payout as % of pre-retirement income (replacement rate), annuity in mixed portfolio (real return of 4.5%), for each percent of income saved*	4.8%	7.8%	10.3%	13.5%	18.0%

\* Stocks roughly 2:1 large company:small company; Bonds roughly 2:3 corporate:government. Assumes income rise 1.1% a year in real terms. Assumes 20 years average lifespan in retirement.

**Table 3: Social Security replacement rates for retirees with various earnings histories, as promised under current law and as funded under current tax rates**

Income categories, 2005:	low wage* (\$15,820)	average wage* (\$35,157)	high wage* (\$56,251)	max. wage* (\$90,000)
Promised replacement rate:	55%	41%	34%	27%
Funded replacement rate:	38%	28%	23%	18%

Percent of income (required carve-out) that must be saved in working years in various portfolios to equal Social Security's promised/funded replacement rates (above). Top line assumes an annuity with a 2.5% real return (all bonds) and bottom line assumes an annuity with a 4.5% real return (60/40 stocks/bonds)\*

working years portfolio	annuity rate	promised/funded low wage	promised/funded average wage	promised/funded high wage	promised/funded max. wage
0/100 stocks/bonds	2.5%	13.9% / 9.6%	10.3% / 7.1%	8.6% / 5.8%	6.8% / 4.5%
	4.5%	11.6% / 8.0%	8.6% / 5.9%	7.1% / 4.8%	5.7% / 3.8%
40/60 stocks/bonds	2.5%	8.4% / 5.8%	6.3% / 4.3%	5.2% / 3.5%	4.1% / 2.8%
	4.5%	7.0% / 4.8%	5.2% / 3.6%	4.3% / 2.9%	3.4% / 2.3%
60/40 stocks/bonds	2.5%	6.4% / 4.4%	4.8% / 3.3%	4.0% / 2.7%	3.2% / 2.1%
	4.5%	5.4% / 3.7%	4.0% / 2.7%	3.3% / 2.2%	2.6% / 1.8%
75/25 stocks/bonds	2.5%	4.9% / 3.4%	3.6% / 2.5%	3.0% / 2.0%	2.4% / 1.6%
	4.5%	4.1% / 2.8%	3.0% / 2.1%	2.5% / 1.7%	2.0% / 1.3%
95/5 stocks/bonds	2.5%	3.7% / 2.5%	2.7% / 1.9%	2.3% / 1.5%	1.8% / 1.2%
	4.5%	3.1% / 2.1%	2.3% / 1.6%	1.9% / 1.3%	1.5% / 1.0%

\*Uniform low wage earner at 45% of average wage; high wage earner at 160% of average; maximum earner at covered wage cap. Figures for 2005, Social Security OASDI Trustees Report.

**Table 4: Carve-out Rates Under Various Reform Plans**

Income categories, 2004:	low wage	ave. wage	high wage	max. wage
Social Security Panel Plan 2: 4% of wages up to \$1,000 contribution (covers 1st \$25,000 of wages)	4.0%	2.8%	1.8%	1.1%
Graham: 4% of wages up to \$1,300 contrib. (covers 1st \$32,500 of wages)	4.0%	3.7%	2.3%	1.4%
Ryan/Sununu: 10% of 1st \$10,000 of wages, 5% of remainder up to max. wage	8.2%	6.4%	5.9%	5.6%
Alternative: 10% of 1st \$10,000 of wages, 2% of remainder up to max. wage	7.1%	4.3%	3.4%	2.9%

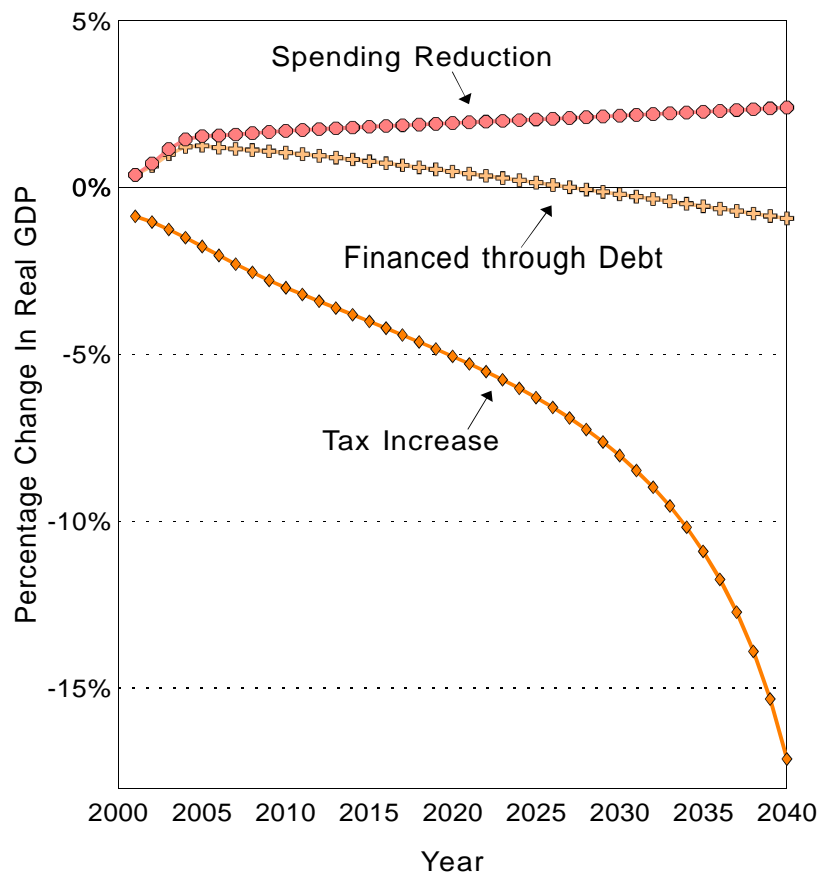


**Table VI.F10.—Estimated Annual Scheduled Benefit Amounts for Retired Workers  
With Various Pre-Retirement Earnings Patterns Based on  
Intermediate Assumptions, Calendar Years 2005-80**

Year attain age 65	Retirement at normal retirement age			Retirement at age 65		
	Age at retirement	Constant 2005 dollars	Percent of earnings	Age at retirement	Constant 2005 dollars	Percent of earnings
<b>Scaled low earnings:</b>						
2005	65:6	9,305	58.3%	65:6	9,003	56.9%
2020	66:2	10,774	56.0%	66:2	9,931	52.2%
2040	67:0	13,298	55.3%	67:0	11,520	48.9%
2060	67:0	16,510	55.4%	67:0	14,309	49.0%
2080	67:0	20,448	55.3%	67:0	17,722	49.0%
<b>Scaled medium earnings:</b>						
2005	65:6	15,335	43.2%	65:6	14,833	42.2%
2020	66:2	17,752	41.5%	66:2	16,366	38.7%
2040	67:0	21,907	41.0%	67:0	18,985	36.3%
2060	67:0	27,200	41.0%	67:0	23,574	36.3%
2080	67:0	33,686	41.0%	67:0	29,194	36.3%
<b>Scaled high earnings:</b>						
2005	65:6	20,222	36.1%	65:6	19,568	35.3%
2020	66:2	23,538	34.4%	66:2	21,704	32.1%
2040	67:0	29,044	34.0%	67:0	25,171	30.1%
2060	67:0	36,063	34.0%	67:0	31,254	30.1%
2080	67:0	44,662	34.0%	67:0	38,707	30.1%
<b>Steady maximum earnings:</b>						
2005	65:6	23,285	30.1%	65:6	22,525	29.7%
2020	66:2	28,764	27.6%	66:2	26,433	25.7%
2040	67:0	35,737	27.2%	67:0	30,758	23.9%
2060	67:0	44,308	27.3%	67:0	38,143	24.0%
2080	67:0	54,866	27.3%	67:0	47,229	24.0%

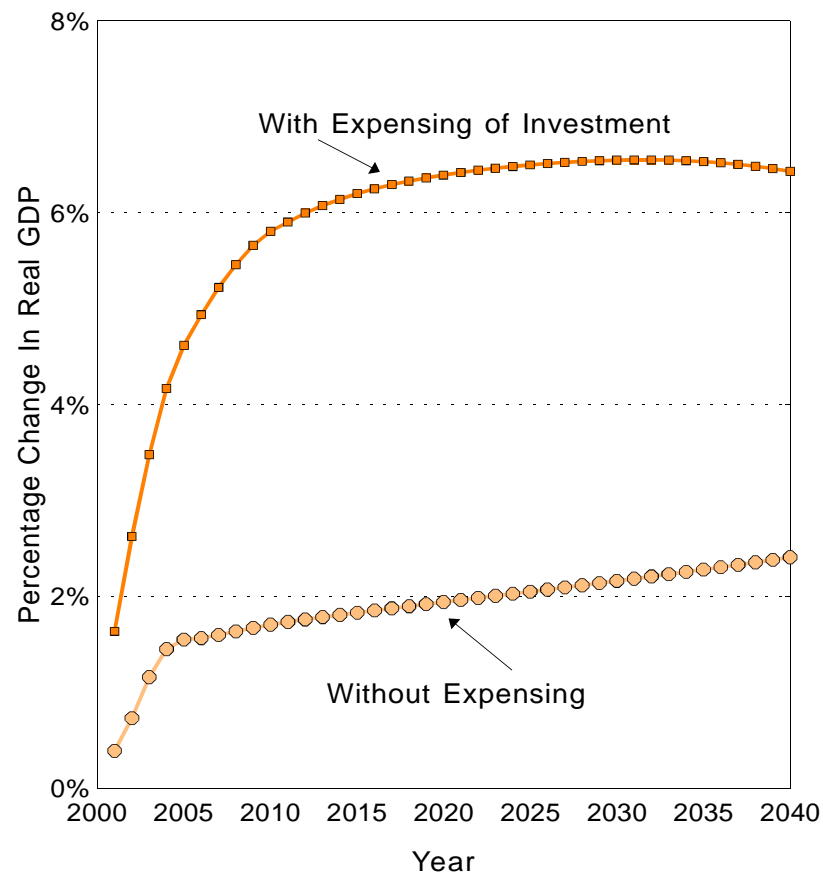
Source: 2005 ANNUAL REPORT OF SOCIAL SECURITY TRUSTEES

**CHART 1 Percentage Change In Real GNP Produced By Social Security Reform Under Various Transition Funding Options**



5% Reduction in OASDI Taxes.  
Changes relative to baseline GDP.

**CHART 2 Percentage Change In Real GNP Produced By Social Security Reform With And Without Investment Incentives**



5% Reduction in OASDI Taxes. Assumes Spending Reduction to Finance Transition.  
Changes relative to baseline GNP.

*Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.*