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Encouraging Financial Security: First Do No Harm

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Abstract: America faces large budget deficits and a near-record low rate of net national savings at the same time that tens of millions of families are approaching retirement with little or no financial cushion for their retirement. Some proposed solutions, like carving private accounts out of Social Security, would be counterproductive. Instead, financial security – both for the nation as a whole and American families – can be advanced a combination of balanced Social Security reform and reforms to make it easier and more rewarding for families to save.

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Encouraging Financial Security: First Do No Harm

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America faces major budget deficits and perilously low national savings. These problems are expected to grow significantly over the coming decades. At the same time, Americans are struggling to plan for their retirements. Reforming Social Security and our private pension system, if done correctly, can play a meaningful role in addressing these challenges.

It is better to act sooner rather than later. But even more important than acting sooner is to obey the Hippocratic Oath: first, do no harm. If done in the wrong way, Social Security and pension reform could worsen our long-run fiscal outlook, depress national savings, and make retirement even less secure.

In my paper I will first discuss the fundamental goals of Social Security and pension reforms. Second, I will explain why President Bush's Social Security plan fails to satisfy these goals. Third, I will evaluate the idea of replacing the President's "carveout" accounts with what proponents call "add-on accounts." Finally, I sketch a better approach to restoring Social Security solvency and encouraging moderate income families to save more.

I. Goals of Social Security and Pension Reform

Social Security and pension reforms should be guided by four principal goals:

1. **Restore Social Security Solvency.** If no changes are made, the Social Security Trust Fund is projected to become exhausted in 2041 and tax revenues will be sufficient to only pay 74 percent of scheduled benefits in that year.¹ The pre-eminent goal of Social Security reform is to ensure that Social Security is sustainably solvent while using only dedicated revenue and avoiding abrupt and dramatic tax increases or benefit reductions in the future.

¹ Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2005 Annual Report of the Board of Trustees of the Federal Old-age and Survivors Insurance and Disability Insurance Trust Funds*, ("2005 Trustees Report"). All estimates in this paper are based on the Social Security Trustees' assumptions.

2. **Address America's Fiscal Challenge – Both in the Short Run and Long Run.** In fiscal year 2004, the federal government ran a unified deficit of \$412 billion, or 3.6 percent of Gross Domestic Product (GDP). Over the coming decades, the combination of phased-in tax cuts, rising health costs, and demographic changes will inexorably lead to significantly larger deficits and debt. Deficits of this magnitude reduce economic growth, increase the likelihood of an economic crisis, and will inevitably require higher taxes or lower government spending in the future. Although Social Security is not the principal source of these deficits, well-designed Social Security reform can and should play a modest role in reducing deficits both in the short run and in the long run.
3. **Strengthen Retirement Security.**² Financial planners recommend having enough income in retirement to replace about 70 percent of pre-retirement income. Social Security plays a critical role in guaranteeing a comfortable retirement for most Americans: more than two-thirds of retirees rely on Social Security for more than half of their retirement income.³ But, the current Social Security system has some deficiencies, including high poverty rates for widows, high poverty rates for older beneficiaries, and the lack of an effective minimum benefit to ensure that retirees do not fall below the poverty line. To supplement Social Security, workers rely on defined contribution plans like 401(k)s and personal savings through IRAs and other vehicles. But about half of Americans work at companies that do not offer pensions and the current system provides little or no tax incentive to help moderate-income families save. Reform can strengthen retirement security by ensuring that future Social Security benefits are adequate, sustainable, and supplemented by additional savings.
4. **Increase National Savings.** Increased national savings would lead to more investment, augmenting the capital stock and thus future economic output. Or, higher national savings would reduce the need for foreign borrowing, which means that Americans would be able to consume more of our future economic output. Increasing national savings is the only way to expand the economic pie. This is the only way to ameliorate the potentially painful tradeoff between future consumption by the young and future consumption by the old. In the last three years, net national savings has averaged 1.6 percent of GDP – the lowest level in seventy years. At the same time, investment was financed by an average 4.8 percent of GDP in capital inflows from abroad, the highest level on record. Borrowing at this level is unsustainable and eventually this debt

² Strengthening disability security is also a critical priority but one that is beyond the scope of this paper.

³ Thomas Hungerford *et al.*, "Trends in the Economic Status of the Elderly, 1976-2000" *Social Security Bulletin* 64:3, January 2003.

will need to be repaid. Social Security and pension reform can help increase private savings *and* reduce government dissaving (i.e., by reducing budget deficits).

Reform should advance these four goals. Any reform that impedes progress on any of these goals must be rejected. For example, it would be easy to make Social Security solvent by transferring trillions of dollars to the Trust Fund, but that would be a fiscal disaster and it would hinder efforts to increase national savings. To give another example, it would be easy to provide new tax incentives for savings. But if these tax incentives are not fully paid for and well-designed they could worsen the long-run fiscal outlook and reduce national savings.

II. The President's Social Security Reform Proposal

President Bush's Social Security is largely moribund. Nevertheless, it is likely that private accounts proposals will be revived again in the future. That is why it is important to analyze the plan closely and understand it as well as possible. While private accounts plans vary greatly, many of them will have elements – and associated problems – in common with the plan the President advanced.

The President's Social Security plan has two parts: voluntary private accounts and sliding-scale benefit reductions modeled on investment executive Robert Pozen's "progressive price indexing" plan.⁴ Although the full details of the plan have never been worked out, sufficient detail has been made available to assess its ability to meet the four principal goals of Social Security and pension reform.⁵

A. The President's Proposal and Social Security Solvency

The President has proposed sliding-scale reductions in Social Security benefits for retirees and survivors. Reductions would start in 2012 and grow over time. The White House states that its "reform would solve 70 percent of

⁴ See White House, "Strengthening Social Security," February 2005 and Stephen Goss, Chief Actuary, Social Security Administration, "Preliminary Estimated Effects of a Proposal to Phase In Personal Accounts," February 3, 2005 and White House, "Fact Sheet: Strengthening Social Security for Those in Need," April 28, 2005.

⁵ All estimates are based on the assumptions of the Social Security Trustees, unless indicated otherwise. Additional details underlying this analysis are available in Jason Furman, "The Impact of President Bush's Proposal on Social Security Solvency and the Budget," Center on Budget and Policy Priorities May 10, 2005 and Jason Furman, "An Analysis of Using 'Progressive Price Indexing' To Set Social Security Benefits," Center on Budget and Policy Priorities, May 2, 2005.

the funding problems facing Social Security," although a more comprehensive accounting would show that the plan closes about 60 percent of the 75-year deficit.⁶ Any measure that does not eliminate the entire 75-year shortfall in Social Security will result in the Trust Fund becoming exhausted at some point in the next 75 years. The President's sliding-scale benefit reduction plan would push back the exhaustion of the Social Security Trust Fund by 6 years, to 2047. After that date, a roughly 15 percent across-the-board benefit cut – on top of the benefit cuts that the President has proposed – would be required to achieve solvency.

The President also proposes to allow workers to divert 4 percentage points of their payroll taxes (up to a maximum amount) into individual accounts. The President's proposal would require workers, in effect, to repay the "loans" these contributions represent through a reduction in their traditional defined Social Security benefit.

The accounts would substantially worsen Social Security's projected shortfall over the next 75 years because under the President's proposal reductions in Social Security benefits to repay the Trust Fund for the funds diverted into accounts would be made with a lag. Some of the funds diverted from Social Security to accounts over the next 75 years would not be repaid until after the end of the 75-year period.

The accounts would also worsen projected solvency over the infinite horizon, but by a smaller percentage. This is because in a significant percentage of cases the benefit offset required to make the accounts actuarially neutral will not be collected. For example, if an unmarried worker dies prior to retirement his or her entire account goes to his or her estate and the benefit offset is not collected. Or take the case of the higher-earner. In many cases, his or her entire Social Security benefit would be less than the benefit offset associated with the account. In those cases, the higher earners' entire traditional benefit would be wiped out but the Trust Fund would not collect the remainder of the benefit offset and solvency would be worsened. This case would apply to anyone with steady earnings at or above the payroll tax cap (now \$90,000 a year) who retires after 2060. There are other such examples.

B. The Fiscal Impact of the President's Proposal

The President's Social Security proposal would result in a large increase in the debt held by the public, in the near-term and over the longer-term (i.e., the next 60 years). The President's accounts would add \$1.5 trillion to the debt over

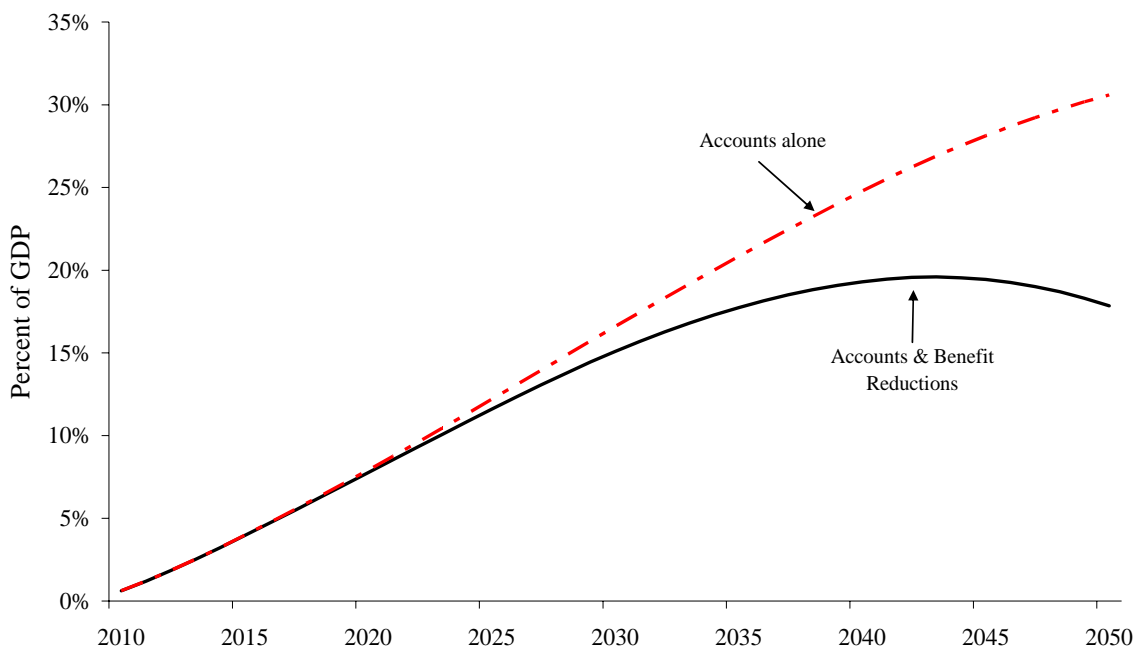
⁶ The Pozen plan closes 70 percent of the 75-year Social Security deficit. The White House modified the Pozen plan, dropping his proposal to reduce disability benefits, and thus closes less of the 75-year deficit.

the first ten years that the plan is in effect (from 2009 to 2018.) The accounts would cause the debt to increase by another \$3.8 trillion in the decade after that, for a total of \$5.3 trillion over the first twenty years.

The sliding-scale benefit reductions that the President is proposing would reduce the debt by relatively modest amounts in coming decades. Over the first twenty years, those benefit reductions would reduce the debt by \$400 billion. The combined effect of the accounts and the sliding-scale benefit reductions the White House is proposing would be to add \$4.9 trillion to the debt over the first twenty years.

The debt would continue to rise after twenty years, both in dollar terms and as a share of GDP, as shown in Figure 1. The accounts, by themselves, would lead to *permanently* elevated debt. Although the sliding-scale benefit reductions would eventually start to bring that debt down, the debt would remain elevated through 2067. This would lead to higher interest payments on the debt, increasing the burden for future taxpayers.

Figure 1. Additional Debt Held by the Public



Source: Author's calculations.

Some have argued that the additional debt associated with the accounts would not be a source of concern for financial markets or the economy more broadly. They argue that, over an infinite horizon, this debt diminishes or disappears and that as a result even the initially high levels of debt should be

considered neutral from an overall fiscal position. The accounts causing no fiscal harm is the best case scenario. No one has argued that the debt associated with the accounts has any fiscal benefits.

There is a significant probability that the debt associated with the accounts would harm the economy.⁷ The borrowing to pay for the accounts would take the form of "explicit debt," that is government bonds. These bonds cannot be defaulted on and must be rolled over or serviced on an annual basis. This explicit debt would replace "implicit debt" in the form of reduced future Social Security obligations. Implicit debt, however, is very different from explicit debt. It does not need to be rolled over or serviced on an annual basis. The total amount of implicit debt is based on projections and is not legally binding, unlike the tangible debt issued in the form of Treasury bonds.

Financial markets, both in the United States and abroad, are likely to be more troubled by the explicit debt than they currently are by the implicit obligations of the U.S. government. Federal Reserve Chairman Alan Greenspan testified that if financial markets did not distinguish between implicit and explicit debt, then the borrowing associated with accounts would have no impact on the market. But he went on to say, "But we don't know that. And if we were to go forward in a large way and we were wrong, it would be creating more difficulties than I would imagine."⁸

The record is replete with nations undergoing fiscal crises because of explicit debt. No nation has undergone a fiscal crisis because of implicit debt.

Furthermore, rational financial markets would understand that the eventual repayment of the debt associated with the President's accounts would be decades in the future and would depend on large and potentially politically unsustainable benefit reductions. To the degree that financial markets partially discounted these benefit reductions or factored in the possibility of a government bailout in the event of a major stock market crash, this added debt would have a significant impact.

As Harvard economist Martin Feldstein explained in a paper he wrote in 2001, he had advised against President Reagan establishing individual accounts in part because "the overall budget was in substantial deficit, starting to fund

⁷ For an extended discussion of these issues see Jason Furman, William G. Gale and Peter R. Orszag, "Should the Budget Rules Be Changed To Exclude the Cost of Individual Accounts," *Tax Notes* January 24, 2005.

⁸ Alan Greenspan Testimony, February 16, 2005.

investment-based accounts would have required a tax increase or an even larger overall budget deficit.”⁹

In summary, the accounts portion of the President’s plan would result in *permanently* higher debt than the same plan without accounts. Even when combined with sliding-scale benefit reductions, the debt would be elevated for more than sixty years. It is important to remember that even from the vantage point of 2067, when the debt would be the same as under current law, the proposal would be judged a failure. The goal of Social Security reform is not to leave the debt the same as under current law, it is to significantly reduce the debt in order to help relieve future fiscal pressures. The debt associated with the President’s accounts proposal would have no upside benefits and substantial downside risks.

C. The Impact of the President’s Proposal on Retirement Security

The President has not proposed any revenue increases for Social Security but instead is proposing to drain revenue from Social Security into individual accounts. Together, this necessitates very large reductions in traditional defined Social Security benefits. The President’s plan includes two sets of benefit reductions. The first benefit reduction is a sliding-scale benefit reduction that would apply to all workers making over \$20,000 per year (and some beneficiaries making even less than \$20,000 per year). The second benefit reduction is the benefit offset that would apply to workers who opt for private accounts. Together these proposals would greatly diminish Social Security – the core tier of retirement security. The large majority of Americans would rely on investments that are subject to market risk for the large majority of their retirement income. Accounts will not necessarily make up for benefit offsets. As a result, workers would be left with substantially lower retirement income than they enjoy under the current-law formula.

The First Benefit Reduction: Sliding-Scale Benefit Reductions

The President is proposing to reduce benefits relative to the current-law benefit formula. This proposal would apply to the large majority of beneficiaries, whether or not they opt for accounts. Under the President’s proposal Social Security would replace a smaller and smaller amount of recipients’ pre-retirement income. These replacement rates are the most meaningful way to compare Social Security benefits over time.

⁹ Martin Feldstein, “Comments on Fiscal Policy and Social Security Policy During the 1990s,” in Jeffrey A. Frankel and Peter R. Orszag (eds.) *American Economic Policy in the 1990s*, Cambridge, MA, MIT Press, 2002.

Social Security replacement rates would be reduced for *all* beneficiaries who make over \$20,000 annually. In addition, as explained below, replacement rates would be reduced for some beneficiaries who make less than \$20,000 annually.

The replacement rates would be reduced more for higher-income beneficiaries. The Social Security actuaries have estimated that the average worker (someone who currently earns \$37,000) would see his or her replacement rate reduced by 16 percent in 2045 and 25 percent in 2075. A so-called "high earner," someone with income 60 percent above the average (or current earnings of about \$59,000) would see his or her replacement rate reduced by 28 percent in 2045 and 42 percent in 2075.

While the President's plan does protect low-income retirees who earn benefits based on their own work histories, it does not necessarily protect people who earn so-called "auxiliary" benefits based on another person's work history. For example, widows, surviving children and ex-spouses all get benefits based on another worker's earnings. If that worker makes over \$20,000 annually (i.e., is in the top 70 percent), the widows, surviving children or ex-spouses would all get benefit cuts – even if the beneficiaries themselves have a much lower income, as they well may in the aftermath of a deceased worker's death or a divorce.

The Second Benefit Reduction: The Benefit Offset for Private Accounts

In addition to the first benefit reduction, workers who opt for the President's proposed private accounts would be subject to a second reduction in their traditional defined Social Security benefit.

Under the President's proposal, workers could contribute up to 4 percent of taxable wages to private accounts. These contributions would be capped at \$1,000 in 2009, with the cap increasing thereafter by \$100 per year, plus wage inflation. By 2041, all workers would be able to contribute a full 4 percent of taxable payroll to their accounts. Workers who elect private accounts would have their traditional Social Security benefit reduced by their contributions to the accounts, plus an interest charge set at 3 percent above the inflation rate.

The combination of the sliding-scale benefit reductions and the benefit offset associated with private accounts would radically transform retirement, leaving the average worker with a fraction of the traditional Social Security benefit he or she is entitled to today. Consider an average worker retiring in 2055, the first worker who would be eligible to participate fully in the President's proposed accounts. The sliding-scale benefit reduction would reduce this worker's scheduled benefit by 21 percent. The benefit offset would reduce the scheduled traditional Social Security benefit by 45 percent. Together, these two

benefit reductions would reduce the traditional defined benefit by 66 percent. This worker would have a guaranteed benefit of only \$7,500 annually, or a replacement rate of about 12 percent of pre-retirement income. The majority of the workers' retirement income would come from the individual account, pensions, and other savings – all of which is subject to market risk.

These double reductions in benefits grow dramatically for higher income workers and workers retiring later. For example, a worker making the equivalent of \$59,000 in today's wage-adjusted dollars and retiring in 2075 would see a 97 percent reduction in his or her traditional defined Social Security benefit. Virtually all of this workers retirement income would come from the individual account and other savings.

The combination of sliding-scale benefit reductions and carveout accounts raise very serious concerns about the unraveling of Social Security. The benefit offset for the accounts is designed in such a manner that it would lead participants to devalue their traditional Social Security benefits (and all the associated disability insurance, life insurance, and other advantages) and overvalue their private accounts. Many Americans would appear to get little or nothing from their traditional Social Security contributions, while lower-income families would still get relatively more substantial benefits. This could lead to significant political pressure to shift more of Social Security into private accounts and reduce defined benefits for lower-income workers.

Would Higher Returns on Accounts Make Up for These Benefit Reductions?

Would the accounts the President is proposing help make up for these benefit reductions? The way the accounts are structured, a participant would need to get a rate of return (after subtracting administrative costs) that is more than 3 percent above the inflation rate to make up for the second benefit reduction, the benefit offset. A rate of return well above 3 percent would generally be needed to make up for both sets benefit reductions.

The President has proposed to set up "lifecycle" accounts as the default option for investors. These accounts would switch portfolio allocations towards bonds as a worker nears retirement. The goal is to capture potentially higher stock market returns while reducing the risks associated with stock market investment. Noted financial economist Robert Shiller, author of *Irrational Exuberance*, however, showed that "lifecycle" accounts do not provide a free lunch and are still subject to considerable risks.

Shiller conducted a simulation using historic returns from 1871 to 2004 to answer the question of whether or not workers would come out ahead of the 3

percent hurdle required to make up for the second benefit reduction.¹⁰ Using actual historical returns, Shiller found that workers opting for a “lifecycle account” modeled on the President’s proposal would end up losing money 32 percent of the time. That is, 32 percent of the time workers would not even make enough to overcome the benefit offset. They would be worse off as a result of opting for the accounts.

Shiller, however, believes that these historical returns are likely to overstate the returns to accounts because future stock market returns are not likely to be as high as past returns. As a result, he conducted the simulation using what he considers more “realistic” returns that are more reflective of future stock market performance. Shiller finds that workers would lose money on the accounts 71 percent of the time. Even the more realistic returns assumed for the second part of Shiller’s study are *higher* than the returns projected by a wide range of financial economists surveyed by the *Wall Street Journal* in February.¹¹

Moreover, even these lower rates of return do not take into account the additional risks associated with equity investment. Virtually all economists agree that any assessment of the likely outcome of this margin loan should take into account the additional risks associated with investing in equities. As Gary Becker, a Nobel Laureate in economics and supporter of individual accounts explains: “There are no freebies from such investments since the higher return on stocks is related to their greater risk and other trade-offs between stocks and different assets.”¹²

The Congressional Budget Office (CBO) uses what is known as “risk adjustment” in estimating the featured returns on private accounts established under Social Security plans. This means that CBO adjusts stock returns to reflect the higher risk that stock investments carry. Under CBO’s analyses, private accounts “are expected to earn an annual return of 3.0 percent [above inflation],” after adjustment for risk.¹³ Risk adjustment makes the balances in private accounts (which are subject to market risk) comparable to the value of the guaranteed Social Security benefit (which is not subject to market risk). Without adjusting for risk, comparing the certain balance in a traditional benefit to the uncertain balance in a private account is misleading.

¹⁰ Robert Shiller, “The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation,” March 2005.

¹¹ Mark Whitehouse, “Social Security Reform Plan Leans on Bullish Market,” *Wall Street Journal*, February 28, 2005.

¹² Gary Becker, “A Political Case for Social Security Reform,” *Wall Street Journal*, February 15, 2005.

¹³ Congressional Budget Office, “Long-term Analysis of Plan 2 of the President’s Commission to Strengthen Social Security,” July 21, 2004. CBO assumes a risk-adjusted rate of return on investment of 3.3 percent, which is CBO’s projected return on Treasury bonds, minus 0.3 percent for administrative and management fees.

From the perspective of risk adjustment, workers would not come out ahead if they opt for private accounts. Private accounts simply introduce substantial additional risk into the core tier of retirement security without doing anything to lessen the sliding-scale benefit reductions the President is proposing.

D. The Impact of the President's Proposal on National Savings

Raising net national savings should be a fundamental goal of any proposal to reform Social Security and pensions. This goal was unanimously accepted by the 1994-96 Advisory Council and endorsed by the President's Commission to Strengthen Social Security. Higher national savings leads to increased investment and/or reduced foreign borrowing. Either way, higher savings is the only way to increase consumption by the elderly without reducing consumption by the young.

The President's accounts proposal (by itself and not counting the benefit reductions), does nothing to raise national savings and could even result in lower national savings.¹⁴ The President's plan would put money into accounts (representing saving) while contemporaneously financing these contributions with higher federal borrowing (representing dissaving). The net effect would be no increase in savings.

One of the leading public finance textbooks, written by the former Chairman of President Bush's Council of Economic Advisers Harvey Rosen explains that "privatization" by itself does not raise national savings:

Hence, privatization can help finance future retirees' consumption only to the extent that it allows future output to increase. And the only way it can do this is by increasing saving.

However, there is no reason to believe that privatization by itself would raise national savings. The government by itself has to finance its deficit one way or another. In order to induce private investors to accept government bonds that would have been bought by the Trust Fund, their yield has to go up (increasing the debt burden on taxpayers), or the yield on stocks must fall, or both. At the end of the day, all that takes place is a swap of public

¹⁴ The benefit reductions in the President's plan could lead to modest increases in national savings over time, although they would do relatively little to pre-fund Social Security by substantially increasing up-front savings. This subsection is concerned with the question of whether the accounts in the President's proposal would further or set-back the effort to increase national savings.

*and private securities between the Trust Fund and private markets – no new savings is created.*¹⁵ (emphasis added)

The primary effect of the President's accounts proposal is no change in national savings. As a result, the proposal fails to meet one of the principal goals for Social Security reform – increasing national savings. Further, two secondary effects could be important.

First, the accounts would reduce savings if individuals treat them as net wealth and consequently decrease their 401(k)s and IRAs savings. The completely rational actor that inhabits economics textbooks should not change his or her savings as a result of the accounts: every dollar contributed to the account is matched by a dollar reduction in present value terms in future Social Security benefits. As a result, the accounts do not represent net wealth but are instead a loan. Workers will still need to save as much of their own money to enjoy a dignified retirement. But, the design of the President's accounts (and the way in which they are often described) could lead many people to ignore the benefit offset associated with the account and to incorrectly assume that the accounts represent new wealth. Such people could feel less need to save in the form of 401(k)s and IRAs.¹⁶ This would not just reduce national savings, it would also leave these people *even less* prepared for retirement.

Second, in theory the accounts could increase savings if the higher deficits associated with accounts lead to lower government spending and/or higher taxes. In this case, the government would not be completely financing the accounts with borrowing and national savings would increase. This theory depends on the behavior of the current government and future governments. The Bush administration has not claimed that if accounts were passed it would propose additional reductions in federal programs or higher taxes to offset the increased deficit. In fact, administration officials emphasize that they do not believe there is any need for such steps because, they contend, the accounts are fiscally neutral over the infinite future. In addition, the Bush administration has not included the short-run deficit impact of the accounts in its budget submissions. It would be imprudent to base a major policy on the hope that future government spending and/or taxes would change as a result.

¹⁵ Harvey S. Rosen, *Public Finance*, Seventh Edition, 2005, p. 208. Rosen goes on to explain that “sophisticated schemes” that include additional out-of-pocket contributions could increase savings. The President's carveout accounts do not have any of the features Rosen identified as leading to higher savings.

¹⁶ Douglas Elmendorf and Jeffrey Liebman provide evidence suggesting that individuals reduce savings by about 40 percent of the value of individual accounts but only increase savings by 25 percent for future reductions in Social Security benefits (like the benefit offset). As a result, they conclude that “individual accounts are likely to crowd out some other household saving.” Douglas W. Elmendorf and Jeffrey B. Liebman, “Social Security Reform and National Saving in an Era of Budget Surpluses,” *Brookings Papers on Economic Activity*, 2:2000.

As a result, the President's accounts proposal, by itself, is likely to reduce national savings permanently. Even with the potentially offsetting effect of the sliding-scale benefit reductions, national savings would likely be lower and America as a whole would be poorer for several decades.

III. Alternative Approaches to Saving Social Security and Encouraging Savings

An alternative to the President's approach would advance all four goals simultaneously: make Social Security solvent, reduce the debt, protect retirement security, and increase national savings.

A. Saving Social Security

Social Security faces a projected deficit of \$4 trillion over the next decade. There is no way to restore solvency without some combination of benefit reductions and tax increases that total \$4 trillion. While neither half of the equation is politically pleasant, both should be part of any sound reform.

Several proposals have been advanced that would make modest changes to Social Security's benefits and taxes in order to restore solvency. One of the most promising proposals was developed by Peter Diamond and Peter Orszag.¹⁷ Specifically, Diamond and Orszag advocate steps that fit into four categories:

- **Addressing increased life expectancy.** Diamond and Orszag point out that the natural response to living longer is a combination of benefit reductions (i.e., reduced consumption in retirement), tax increases (i.e., reduced consumption during working years) and retiring later. Unlike many plans which advocate reducing benefits to cope with longer lives, Diamond and Orszag sensibly propose dividing this adjustment between payroll tax increase and benefit reductions.
- **Adjusting for increased earnings inequality.** Part of Social Security's deteriorating financial outlook is the result of increased earnings inequality. As a result, more earnings are falling above the payroll tax cap and thus no longer represent Social Security revenue. Diamond-Orszag, like several other plans, propose to remedy this by gradually raising the cap.
- **Sharing the legacy debt.** Social Security was established as a pay-as-you-go system. As a result, the first generation got windfall benefits –

¹⁷ Peter Diamond and Peter Orszag, *Saving Social Security*, Brookings Institution Press, Washington DC: 2003.

and the system accrued what is known as “legacy debt.” Any plan, with or without accounts, will need to repay, or at least stabilize, this legacy debt. Diamond-Orszag propose to do it with modest benefit and tax changes combined with a “legacy charge” on earnings above the payroll tax cap, currently \$90,000.

- **Improving social insurance.** Several low-cost steps could improve Social Security’s ability to reduce poverty, including making benefits more generous for widows and strengthening the virtually non-existent minimum benefit.

An important consideration in designing a Social Security plan should be “robust solvency,” that is ensuring that Social Security remains solvent (and not overly solvent) even if we are currently wrong about our economic and demographic projections. Diamond-Orszag advances this goal by indexing benefits and payroll taxes to life expectancy. A further step would index some combination of benefits and taxes to the dependency ratio – that is the ratio of beneficiaries to workers. This is a more comprehensive demographic measure that reflects not only life expectancies but, even more importantly, delayed fertility and factors like immigration.

B. Making Saving Easier and More Rewarding

The median family approach retirement with virtually no retirement savings. In part, this is because low-income families get few tax benefits for saving. More importantly, recent economic research has stressed that behavioral factors are a much more important determinant of savings than relatively small variations in the after-tax rate of return. While families often want to save more, often they are busy and do not take the necessary steps or plan to start saving next year. From this perspective, one of the major advantages of a 401(k) is that it makes it easier to save and helps to solve the procrastination problem.

An agenda to encourage more families to save should start with improving 401(k)s to make them more automatic, a process proposed by numerous economists including David Laibson, Bridget Madrian and Richard Thaler and advanced by Peter Orszag, William Gale and others. This proposal would make the default choice for employees participating a 401(k), unless the employee filled out a simple form opting out. In addition, the proposal would offer automatic escalation of payments, sensible and balanced options for automatic investment, and automatic rollover of the balance into an IRA after the employee departs. None of these steps would be coercive, they would simply embody a recommendation and make it easier for busy families to save. Any family that chooses not to save could continue to make this choice.

Second, it should be easier for families to save in IRAs. One step would allow workers to direct a portion of their tax refund into an IRA. In addition, the dozens of different savings accounts with different and confusing rules should be consolidated into one or two simple accounts.

Third, low-income families should be less penalized for their saving. Specifically, the asset tests for means-tested programs should be relaxed. Right now low-income families have the lowest after-tax, after-transfer rates of return on savings. Instead, they should have the highest.

Finally, savings should be more rewarding for middle-income families. The saver's credit provides up to a one-to-one match for saving. This should be expanded and made refundable to ensure that all workers benefit.

It is critical that any steps to promote individual savings should meet two criteria. First, they should genuinely encourage new savings – and limit the windfall rewards for existing savings. The provisions to make savings easier would almost entirely lead to new savings and provide very little of a windfall for existing savers. Expanding the saver's credit would also be well targeted because it targets moderate-income families, a group that saves relatively little today. In contrast, proposals to expand tax incentives for high-income families are likely to largely provide windfall rewards for existing savings.

Second, any new savings proposals should be fully offset by other tax increases or spending reduction and not add to the deficit. It would be counterproductive to advance retirement savings while setting back the attempts to address American's fiscal challenges. More importantly, a poorly targeted proposal might do little to increase private savings. If it is not offset, the resulting deficits could end up leading to a net reduction in national savings.

IV. Conclusion

Social Security faces a challenge and it is better to address this challenge sooner rather than later. But before tackling Social Security's long-term solvency we should mind the words of the Hippocratic Oath and first, do no harm. Carveout accounts would do substantial harm: they would reduce the solvency of Social Security and add trillions of dollars to the debt while making retirement less secure and potentially reducing national savings. Add-on accounts that are financed by increasing the debt – either in the short run or the long run – would also be counterproductive and harmful.

A balanced set of reforms that modestly increases Social Security's revenues while modestly decreasing benefits could ensure that Social Security is sustainably solvent. Such reforms would help reduce long-term budget deficits and increase national savings. A series of reforms could also help strengthen retirement security by making it easier and more rewarding for families to save.