A Perfectly Good Model For Social Security Reform

By Kenneth J. Kies

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White House officials have stressed that President Bush has not settled on all the specifics of a Social Security reform proposal and wants to work with Congress to finalize a plan. When one considers some of the options recently suggested by outsiders, I take that as a positive. Before the president firms up a proposal, he and his advisers should give serious consideration to a framework that was first developed in 1998 by then-House Ways and Means Committee Chair Bill Archer, R-Texas, and Rep. Clay Shaw, R-Fla., then-chair of the Ways and Means Social Security Subcommittee.

It is remarkable that no one today seems to be discussing the Archer-Shaw plan, the "Social Security Guarantee Plan." The proposal was certified by Social Security actuaries as making the Social Security trust fund solvent (that is, able to pay full scheduled benefits) for the next 75 years and beyond — the proper yardstick for all proposals — and would do so without cutting benefits or increasing taxes. The Archer-Shaw proposal also has the benefit of being simple to understand, unlike some other plans. All open-minded policymakers interested in Social Security reform, other than those entrenched in the "do-nothing" camp, should take a fresh look at the proposal as a possible model for reform today.

A 'Workout' Approach

Before turning to the Archer-Shaw proposal itself, I want to suggest a framework for evaluating the Social Security trust fund's fiscal predicament. When I try to get my arms around the situation, I find it helpful to imagine that the fund is a distressed corporation and that I am a bankruptcy workout specialist assigned to address the fund's looming insolvency. A workout specialist would first take stock of the distressed entity's balance sheet, its assets, and its liabilities. In the case of Social Security, the specialist would find a massive liability — the obligation to make benefit payments to growing numbers of retirees in the future — and two principal assets. The first is the inflow of payroll tax revenues, which will be insufficient to meet benefit payments over time. The second asset is the ability of the entity to borrow at very favorable rates.

I don't think it would take a workout specialist long to realize the benefit of having the entity borrow, invest the proceeds in holdings that will generate rates of return in excess of the borrowing interest rate, and use the spread to offset the retiree benefit funding shortfall. Further, I think the specialist would recommend that this action be taken immediately. This was precisely the conclusion reached by Archer and Shaw when they developed their Social Security plan.

The Archer-Shaw Proposal

Consistent with the president's principles, the Archer-Shaw proposal centers on the creation of personal accounts. The federal government would create an account for each of the 136 million current workers and would contribute an amount equal to 2 percent of the Old Age, Survivors, and Disability Insurance (OASDI) wage base per worker each year. Individuals would direct the investments, choosing among an array of mutual funds that would each have to satisfy a conservative investment strategy determined by a government board. Earnings would accumulate tax free. In the meantime, payroll taxes would continue to be collected as under current law and deposited in the Social Security Trust Fund. It is important to emphasize that under that approach, no part of Social Security taxes or the Social Security Trust Fund would be diverted to fund the personal accounts.

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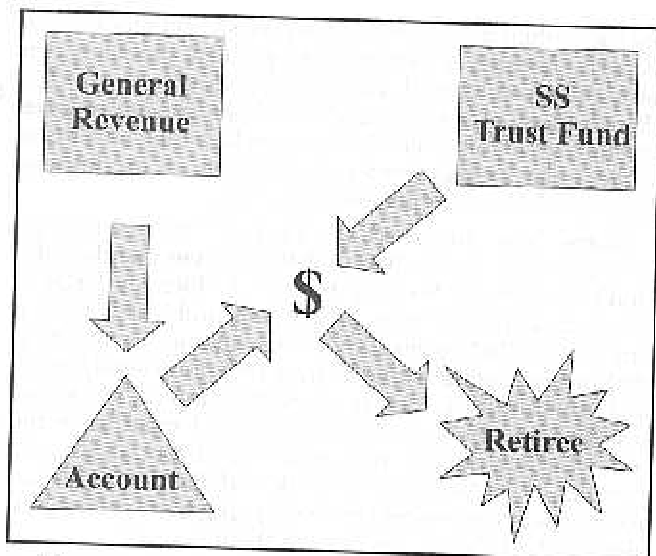
The amount of Social Security benefit that the account holder would receive would be determined, in part, by the balance in the personal account at the time the account holder applies for Social Security benefits. At that time, the Social Security Administration (SSA) would compute the monthly amount payable over the individual's expected remaining lifetime based on the balance in the account. The individual is paid that amount each month. If the monthly payment from the personal account does not at least equal the individual's current-law Social Security monthly benefit, the Social Security Trust Fund makes up the shortfall — the individual's monthly check will be no lower than the amount calculated under current law. If the amount paid over from the personal account each month is greater than the current-law Social Security monthly benefit, the individual pockets the excess.

For example, assume that Mr. Smith elects to receive a Social Security benefit at age 65 and that the monthly benefit to which he would be entitled under current law is $1,200 per month. If a monthly payment from Mr. Smith's personal account is $1,300, Mr. Smith's monthly benefit check from the SSA would be $1,300. In the alternative, if the monthly payment from the personal account is only $900, Mr. Smith would still receive his full Social Security benefit of $1,200 per month. The Social Security Trust Fund would contribute the difference.

That is not a radical idea. It represents partial funding of Social Security benefits during the working life of the



beneficiary. Thirty-one years ago, Congress, through enactment of the Employee Retirement Income Security Act of 1974, imposed a significantly more stringent funding requirement on private-sector qualified retirement plans, generally requiring employers to fully fund those programs before plan participants retire. Thus, the Archer-Shaw plan, in effect, would partially impose on the Social Security system the same type of funding rules that have applied to private-sector qualified plans for the past three decades.

The AARP has run advertisements describing Social Security personal accounts as a risky endeavor, not unlike playing roulette. In reality, as discussed above, the Archer-Shaw plan entails no such risk. Social Security recipients are guaranteed at least their base level of Social Security benefit as promised today. The individual account holder can only do better under the personal account approach. It is unreasonable to assume that Congress would enact a plan that places retirees at risk of losing Social Security benefits, and supporters of personal accounts should not suggest doing so. Even Chile, a pioneer in this area, guaranteed a minimum pension benefit when it introduced a government-sponsored personal account program in 1981 as a means of easing strains on a "pay as you go" government pension. If one adopts the Archer-Shaw guarantee approach, one can easily respond to the ad campaigns of the AARP.

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Another attractive, but not widely discussed, feature of the Archer-Shaw plan is that any amounts remaining in the personal account when a worker or retiree dies could be passed on tax-free to heirs regardless of their age or relationship to the deceased. By contrast, the current Social Security program provides full survivor benefits only to widows age 65 and older and children under age 18. That facet of the proposal is one reason why workers now nearing retirement age, who might not be able to build account balances in excess of lifetime Social Security benefits before they quit work, should support Archer-Shaw. Even though the amounts in the account would not increase monthly retirement benefits, any amounts still left in the account when the worker dies would be an asset the worker could leave to his or her family.

Impact on Social Security Trust Fund

The Social Security trust fund, essentially a collection of federal IOUs, has long run a surplus. The fund balance at the end of each year equals the previous year-end balance plus incoming payroll taxes, plus earnings (that is, interest payments made by simply putting more federal IOUs into the fund), less Social Security benefit payments. In 2003 the fund had income (that is, payroll taxes plus earnings) of $631.9 billion and expenditures (that is, benefit payments) of 479.1 billion, producing a net $152.8 billion increase in fund assets.

The picture gets bleaker over time, as the baby boomers retire and fewer workers replace them. In 2020 the fund is projected to begin running a deficit, according to the latest Congressional Budget Office estimates, as annual fund revenues no longer keep pace with annual benefit payments. In 2052 the trust fund will be totally depleted, in which case full Social Security benefit checks can no longer be mailed out. (The latest SSA projections show a deficit beginning in 2018 and exhaustion of the trust fund in 2042.)

The Archer-Shaw plan would avert that disaster. Payroll taxes would continue to be deposited in the Social Security trust fund and would continue to generate earnings, just as today. However, the ultimate withdrawals from the personal accounts would mean less pressure on amounts otherwise set aside in the trust fund. As a result, the trust fund would be able to make full benefit payments in 2052 and permanently thereafter.

Of course, one also must factor in the up-front cost to the federal government of funding the personal accounts. We assume the government would borrow initially to fund the accounts. As the workout specialist would recognize, the government's cost of borrowing is more than offset over time by the returns on the invested amounts. If you borrow, say, $1 trillion at 2 percent, and earn a return of 5 percent when you invest the borrowed amounts, you will do quite well. Indeed, Social Security actuaries in 1998 estimated that enactment of one version of the Archer-Shaw plan would have a net positive impact on the unified budget in nominal dollars of $88 trillion (that is not a typo) over 75 years and $22 trillion (also not a typo) in real dollars. Over time, those inflows would be sufficient to allow lawmakers to consider reducing payroll taxes.

By Comparison: The Alternatives

Now for the fun part: Comparing the Social Security Guarantee Plan to other reform proposals advanced to date.

Some parties, mindful of the potential political risks, have proposed simply doing nothing about Social Security for the time being. Unfortunately, the trust fund's looming insolvency will become only harder to head off the longer we wait. According to the 2004 Social Security

Trustees Report, if we wait until 2042 to take action, we could keep the trust fund solvent by increasing the OASDI share of FICA tax from 12.4 percent to 16.91 percent, and then up to 18.31 percent by 2078. Alternatively, trust fund solvency could be achieved by reducing benefits by 27 percent in 2042 and continuing to cut benefits until a 32 percent reduction is reached in 2078. Those are not pleasant options. And if we take too long to establish a personal account system, those accounts will not "ripen" (that is, grow to where they begin substantially reducing pressure on trust fund outlays) in time to keep the fund from going broke. (In political terms, those are career-ending options.) While many of us will not be around in 2042 and 2078, the time to make adjustments is clearly now.

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That said, many pundits are betting that the do-nothing camp will prevail, at least for now. If the 1983 Social Security experience is any indicator, they may be right. Recall that the Greenspan Commission warned that Social Security benefits could not be paid on time beginning in July 1983 unless program reforms were adopted. Essentially forced to act, Congress passed remedial legislation in April, heading off a massive political disaster with just months to spare. By comparison, the same crisis point we face today is at least 38 years away (48 by CBO's numbers). Today, waiting is surely the path of least resistance. It is also the cowardly choice.

Others have proposed increasing taxes to alleviate pressure on the Social Security Trust Fund. For example, Sen. Lindsey Graham, R-S.C., has advanced the idea of raising the OASDI wage base, now set at $90,000. Some have proposed raising the cap to $150,000. Taking into account the employee's share of the payroll tax (6.2 percent), that's a tax increase of $3,720 on a worker making $150,000. A family of four or five with income of $150,000 is hardly "wealthy," and may have great difficulty paying the additional tax. Further, the wage tax increase on the employer — another $3,720 — can only depress the worker's salary, not to mention other adverse economic ramifications. I find it highly unlikely that this administration, or the Republican-controlled Congress, would agree to any kind of tax increase when Social Security can be made solvent without such a move. I doubt that a Democratic-controlled Congress would do so either.

Equally unrealistic, in my view, are proposals to reduce Social Security benefits. It is worth noting that a number of advocates of benefits cuts — the so-called pain caucus — are former elected officials, now situated in think tanks and other public policy advocacy groups. No longer answerable to the electorate, those observers are not subject to a rigid current-day political maxim: Discussing benefit cuts is a sure path to terminating one's status in elected office. The opposition already sparked by conceptual discussions of how we should index Social Security benefits underscores the political problems that any proposed benefit adjustments would entail. The Archer-Shaw plan shows that Social Security reform does not have to involve benefit cuts — in fact, total benefits to retirees can increase under the proposal in the form of larger payouts from personal accounts.

Some have advanced the idea of "means testing" Social Security, on the theory that wealthier people really don't need Social Security benefits to live comfortably. While that may be true, a very real problem with that approach is that the wealthy are few in number, meaning that means testing would deliver only a relatively minimal amount of savings, far from the amount needed to restore solvency. Further, I'm not sure I want to be the one who tells seniors who have earned Social Security benefits by virtue of their work and lifetime FICA tax payments that those benefits were going to be paid out all along only if they really needed them.

Another idea put forward is to raise the Social Security retirement age, now 67. While it is true that life expectancies have increased since the dawn of the Social Security program (and since 1983, when the retirement age was increased from 65), such a move would place a far greater strain on blue-collar workers, who may be unable to continue working in their late 60s. Another significant issue is a potentially disparate racial impact given differing life expectancies among racial groups.

The Right Plan at the Right Time

Polls consistently show that most people do not believe they ultimately will receive the Social Security benefits to which they are entitled. Restoring confidence in the Social Security program would be a historic accomplishment. In the eyes of voters under age 40, who may think they stand a better chance of seeing a UFO than receiving any Social Security benefits at all, enactment of the Archer-Shaw plan would be viewed as the equivalent of enacting the Social Security program in the first place.

In my view, the sole focus of the administration and Congress should be on making Social Security permanently solvent. While other objectives (for example, encouraging "ownership") may have great merit, the introduction of multiple themes and goals may begin to erode political support. Lawmakers of all stripes should be able to agree that making Social Security permanently solvent is a good objective. For President Bush, it would clearly be a legacy-making achievement of enormous proportions.

To the extent that implementation of the plan has collateral benefits, all the better. When 130 million-plus individuals receive monthly mutual fund statements showing investment returns, more and more people would come to understand the benefits of saving, the power of "compounding interest," and the important link between a growing economy and their own financial well-being. Many would be encouraged to save even more, furthering the goal of an ownership society in a way that could only be dreamed about in the past.

Perhaps the Archer-Shaw plan sounds too good to be true. It involves no benefit cuts or tax increases. The

"tricks" are simple. As discussed above, the plan generates a gusher of budgetary inflows by arbitraging low borrowing costs and higher rates of return. Another critical feature is the fact that the accounts would be mandatory, which ensures the maximum benefits of the investment spread. Other proposals being discussed involve voluntary accounts, in which case a low take-up rate may mean the intended budgetary benefits of the investment spread are never realized. The mandatory nature of the Archer-Shaw plan should not be a concern because the accounts can work only to the benefit of the retiree.

As I see it, the only downside is that the Archer-Shaw plan would require borrowing today of admittedly substantial amounts to prefund the personal accounts. I would submit that this debt should not raise the same types of concerns that policymakers have about additional borrowing to fund increased spending. First, as discussed above, the return on the borrowed amounts would more than offset the cost of borrowing over time. Second, the borrowed funds would be returned immediately into the economy, as private capital, in the form of the stock and bond investments. For people who hate the idea of additional government borrowing, that is as good as federal debt gets.

A question for the White House and other policymakers is whether this up-front borrowing is preferable to the grim alternatives of cutting retirees' benefits or increasing taxes on workers. Another key question for those same policymakers is whether those grim alternatives have any realistic possibility of being enacted.

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