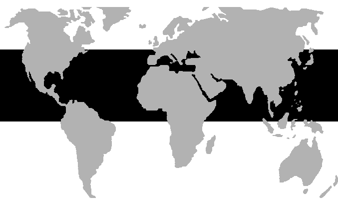

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Two Cheers for the Commission to Strengthen Social Security

By Matt Moore

President Bush created the Commission to Strengthen Social Security in May 2001 to develop a plan to reform the nation's retirement system. The commission's final report to the White House includes three broad frameworks for reform and leaves it up to Congress and the administration to develop the details.

All three options include a provision that allows workers to invest a portion of their Social Security taxes in a personal retirement account (PRA). All provide participating retirees the opportunity to earn a benefit at least as large as that provided to today's retirees — and possibly a benefit greater than the current system provides. Two of the three options include increased benefits for low-income workers and spouses of deceased workers and return Social Security to annual surpluses within the 75-year valuation period.

Option One. This option integrates PRAs into Social Security and does not include any other changes to the current system. It does not fully solve the current system's long-term insolvency within the 75-year valuation period without the infusion of additional revenues.

- *Personal Account Contribution:* Workers who choose to participate would invest 2 percentage points of their 12.4 percent Social Security tax in an individual account.
- *Benefit Offset:* The retiree's monthly benefit consists of a reduced payment from the government to be made up by a payment from the PRA. If the account earns a conservative 3.5 percent real rate of return annually, the account holder would receive a benefit equal to that promised under current law; if the account earns more than 3.5 percent, the investor gets to keep the overage as a bonus.
- *No Other Changes:* No other changes would be made to the traditional Social Security system.

Under this plan a large funding gap will remain; also, additional revenues will be needed by the mid-2030s.

Option Two. The second reform option includes personal accounts, and also makes changes to the current system.

- *Personal Account Contribution:* Workers could invest 4 percentage points of their Social Security tax in an individual account, up to a maximum of $1,000 per year (which is indexed to wages).
- *Benefit Offset:* Benefits are paid in the same manner as Option One. If the account earns a 2 percent average real rate of return, the account holder would receive a pension equal to the reformed benefit level. If the account earns more, the investor receives a larger benefit than the reformed benefit.
- *Protection for Low-Income Workers:* By 2018, a benefits floor would be implemented that protects low-income workers with a guaranteed benefit equal to 120 percent above the poverty level; the current system provides no such guarantee.
- *Protection for Spouses:* Surviving spouse benefits would increase from the 50 to 66 percent of couple benefits under the current system to 75 percent under the new system.
- *Reduce Future Benefit Growth:* This plan would reduce the annual rate of growth in Social Security benefits by tying benefit increases to the Consumer Price Index rather than wage growth starting in 2009.

Option Two reduces Social Security's long-term financial shortfall by 34 percent relative to current law. Additional funds in excess of currently projected Social Security expenses will be needed to fund the transition from 2006 to 2031, at which time the new system will be permanently less expensive than the current one. Over the long run, however, the borrowed funds could be more than paid off. Most importantly, while the current system will slip into annual debt by 2016 and never recover, Option Two returns Social Security to positive annual balances by 2058 (if all workers participate; 2062 if no one participates). By 2075, the program is projected to run an annual surplus of $588 billion.

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Option Three. This plan is the most comprehensive of the three, and makes more changes to the current system than Option Two.

- *Personal Account Contribution:* Workers who invest 1 percent of payroll (in addition to their Social Security taxes) into a PRA may also divert 2.5 percentage points of their 12.4 percent Social Security tax — up to a $1,000 maximum — to the account.
- *Benefit Offset:* Benefits are paid in a manner similar to Options One and Two. If the account earns 2.5 percent, the account holder receives the reformed benefit; if the account earns more, the investor keeps the bonus and receives a larger benefit than the reformed benefit.
- *Protection for Low-Income Workers and Spouses:* Like Option Two, this plan would increase benefits for low-wage workers, guaranteeing them a benefit equal to 100 percent of the poverty level and increase benefits for surviving spouses to 75 percent of couple's benefits.
- *Reduce Future Benefit Growth:* Government-paid benefits would be tied to life expectancy starting in 2009.
- *Other Changes:* The current benefit formula will be further changed to increase the benefits of late retirement, increase the penalties for early retirement and reduce define benefits for higher-income retirees.

Option Three reduces Social Security's long-term financial shortfall by 32 percent. Additional funds in excess of currently projected Social Security expenses will be needed from 2009 to 2031, at which time the new system will be permanently less expensive than the current one. However, this option requires the continued transfer of general revenues to fund the 1 percent add-on contribution to the accounts. This option restores Social Security to positive annual balances by 2062 (if all workers participate). By 2075, Social Security is projected to run an annual surplus of $838 billion.

Over Time, PRAs Alleviate Pressures on the Current System. Some media coverage of the commission's plans suggests that the adoption of personal accounts will require benefit cuts. This is not the case. The commission's plans would allow workers to earn a pension equal to the real value of today's benefits if the worker's account earns an overly-conservative rate of return of 3.5 percent (Option One), 2 percent (Option Two) or 2.5 percent (Option Three). A recent NCPA study demonstrates that over any 35-year period over the past 128 years — including the Great Depression and numerous recessions — a balanced market-wide portfolio earned 6.4 percent per year. Thus, on average, retirees will earn a benefit greater than the reformed benefit and close to or greater than benefits provided under the current system.

To get a third cheer, we need to evolve to a completely funded, private system.

Some of the media coverage failed to explain that since workers with PRAs will draw a portion of their pension from their PRA, the government pays only a portion of the full benefit and thus saves money. Over time, the reformed system is able to repay whatever funds it has borrowed for the transition. By contrast, the current system never returns to annual surpluses and the debt continues to grow into perpetuity. Thus without reform, future retirees will face cuts of up to one-third of their Social Security benefits.

Conclusion. The commission deserves two cheers for its recommendations. (To get a third cheer, we need to evolve to a completely funded, private system.) While they may not be perfect, the three options provide a starting point for Congress and the public to begin a serious discussion about the future of Social Security.

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