Joint Economic Committee Democrats

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Economic Policy Brief — Updated April 2005

The Negative Impact of Private Accounts on Federal Debt, Social Security Solvency, and the Economy

Introduction

The President's Social Security plan, as announced in his State of the Union address (SOTU plan), would partially replace guaranteed benefits with private accounts. The analysis in this report shows that the plan would increase federal debt, weaken the solvency of Social Security, and do nothing to increase national saving.

While President Bush has discussed the private account component of his plan, he has yet to specify the cuts in guaranteed benefits or other measures that would be necessary to restore Social Security solvency. However, benefit cuts are specified in a plan developed by the President's Commission to Strengthen Social Security (PCSSS plan). President Bush has called that plan a "good blueprint," and both a leaked White House memo and recent press reports suggest that the Administration is considering cuts that are consistent with the PCSSS plan.[1] The cuts in guaranteed benefits envisioned in that plan are large and would apply to everyone, not just those who choose to open a private account.

In this report we compare the SOTU and PCSSS plans. We present estimates of the likely increase in federal debt from the President's plan over both the near term and the next 75 years. We explain why the President's plan would weaken Social Security's long-term solvency and thus why claims that the increase in debt is merely a swap of future debt for current debt are false. We discuss why the President's plan will not increase national saving and thus why it cannot help promote economic growth.

Background: The SOTU Plan and the PCSSS Plan

Both the SOTU plan and the PCSSS plan "carve out" private accounts from existing payroll tax contributions and impose a "privatization tax" on the guaranteed benefits of private account participants to recoup the costs of funding those accounts. The SOTU plan does not specify additional cuts in guaranteed benefits or other policies that would be necessary to restore long-term Social Security solvency. The PCSSS plan does include large benefit cuts for everyone, in addition to the cuts in guaranteed benefits for those who choose to open a private account.

The SOTU plan. The SOTU plan phases in voluntary private accounts beginning in 2009 for workers under age 59. Workers could voluntarily contribute one-third of payroll taxes (4 percentage points of the 12.4 percent tax), up to a cap of $1,000. The cap would rise over time, allowing more and more higher-earning workers to contribute a full 4 percent of earnings. Specifically, the $1,000 cap would increase by $100 each year and it would be indexed to keep pace with the growth in average wages. However, the descriptions of the SOTU plan released thus far do not indicate whether the annual $100 increase in the contribution limit continues after 2015. Without further increases after 2015, some higher earning workers would not be able to contribute a full 4 percent of earnings.

Workers opting for private accounts would also agree to pay back the amount they contribute to private accounts with interest. The interest rate would be 3 percent above the rate of inflation (a 3 percent real rate). Upon retirement, workers would pay back Social Security through a reduction in their guaranteed Social Security benefit.

If a worker's private account earned a 3 percent rate of return after inflation (the future rate on Treasury bonds assumed by SSA) and after administrative costs, then the cutback in the guaranteed benefit would equal the entire gain from the private account. If the private account earned a higher 4.6 percent rate of return above inflation (the rate assumed by SSA on a mix of stock and bond investments) and after administrative costs, then the cutback would equal about 70 percent of the private account. If the private account earned less than a 3 percent rate of return, then the cutback would exceed 100 percent of the private account balance, and the worker would be worse off for having chosen to open an account. (See **Box 1** for an example)

The PCSSS plan. The PCSSS plan carves out private accounts in much the same way, with two notable differences. First, the $1,000 cap never increases beyond the adjustment to keep pace with the growth in average earnings. As a result, high-wage workers could never contribute an amount equal to 4 percent of their earnings. Because the PCSSS plan limits the contributions of high-wage workers, its private accounts are much more progressive than the SOTU plan. Second, the privatization tax on guaranteed benefits is smaller under the PCSSS plan. The interest rate applied to contributions to determine the amount a worker must "pay back" is set at the Treasury rate minus one percentage point. If the Treasury rate is 3 percent, the interest rate applied in computing the benefit cutback is 2 percent.

In addition to the privatization tax, the PCSSS plan would substantially cut guaranteed benefits for everyone – even for workers who do not elect private accounts. Under current law, benefits paid in the first year of retirement are indexed to grow with wages. The PCSSS plan indexes these benefits to grow with prices, which typically rise more slowly than wages.[3] As a result, guaranteed benefits for each successive cohort of retirees would replace a shrinking percentage of pre-retirement earnings.

Box 1: An Example of How the Privatization Tax Would Work

The Social Security Trustees' report projects that a medium-earning worker who retires at age 65 in 2055 will receive an annual retirement benefit of $22,351 (in 2005 dollars) under current law.[2] If that worker were to contribute 4 percent of earnings to a private account starting at age 21, the total amount of contributions, including interest compounded at a 3 percent interest rate, would equal $156,000 (in 2005 dollars) at retirement. That is the amount the worker would be required to "pay back" to Social Security. That debt would be repaid in monthly installments by reducing the worker's guaranteed Social Security benefit (the privatization tax). The tax on guaranteed benefits would be about $10,500 per year, reducing the annual guaranteed benefit to about $12,000—a little more than half the original amount.

At retirement, workers would keep the full amount accumulated in their private accounts. If the worker in the example above were able to accumulate more than $156,000 in his or her private account, then he or she would have more retirement income from the combination of the private account and a reduced Social Security benefit than from the unreduced Social Security benefit alone. In order to accumulate more than $156,000, however, the worker would need to earn more than 3 percent after inflation and administrative costs on his or her private account investments.

SSA estimates that this switch to price indexing would cut guaranteed benefits by 46 percent for average earners retiring in 2075.[4]

Analysis by the Congressional Budget Office (CBO) shows that private accounts would not make up for the severe cut in guaranteed benefits in the PCSSS plan. CBO estimates that the PCSSS plan would cut guaranteed benefits by $17,100 for average-earners retiring in 2065, while the private account benefit for those workers would amount to only $5,300, on a risk adjusted basis.[5]

Together, the reduced guaranteed benefit and private account benefit under the PCSSS plan would be 45 percent less than the benefits promised under current law for an average-earner retiring in 2065.[6] Combined benefits under the PCSSS plan would be 27 percent less than the benefits that actually could be paid from projected Trust Fund revenues under current law.[7]

Private Accounts and Government Debt

A large increase in debt. The SOTU plan would require massive increases in federal borrowing and would significantly increase federal government debt.

The Administration estimates that the increase in the debt would be $754 billion over the ten-year budget window 2006-2015. Those estimates understate the true costs, however.[8] The plan does not take effect until 2009, and even then the contribution limit rises gradually over time. If the annual $100 increases in the contribution cap stop after 2015, the plan would increase debt by an estimated $1.4 trillion over the first ten years it is in effect (2009-2018), and by an additional $3.5 trillion over the second decade (2019-2028) **(Table 1)**.

If increases to the contribution cap continue after 2015, which would be necessary to enable all workers to contribute a full 4 percent of taxable earnings, the

Table 1

A $5 Trillion Increase in Federal Debt in the First Twenty Years

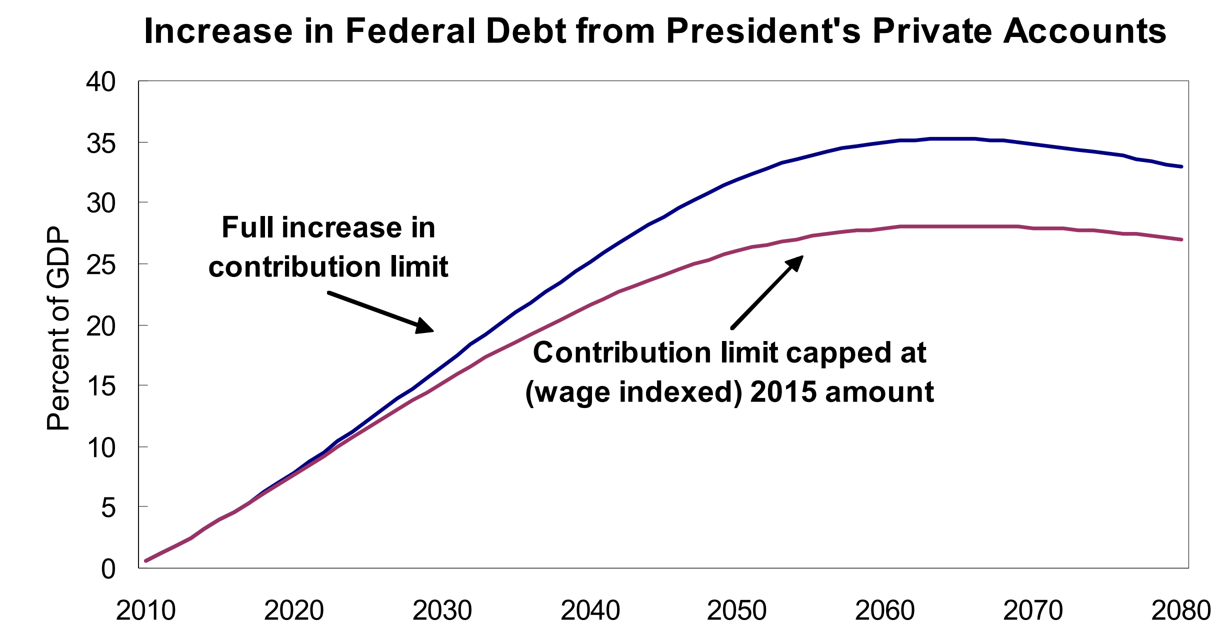
	Increase In Federal Debt from Private Accounts (trillions of dollars)		
Calendar years	Contribution Limit Increased only by Wage Growth After 2015	Full Increase in Contribution Limit	Full Increase in Contribution Limit and Price Indexing of Initial Retirement Benefits
2009 - 2018	1.4	1.4	1.5
2019 - 2028	3.5	3.8	3.3
2009 - 2028	4.9	5.2	4.7

Source: Center on Budget and Policy Priorities and Joint Economic Committee Democratic staff.

Notes: The Administration estimates that the plan would cost $754 billion over fiscal years 2006-2015. The price indexing proposal also contains small benefit increases for low-wage workers and survivors. Because those benefit increases take effect sooner than price indexing of future benefits, there is a small increase in costs in 2009-2018 when price indexing is added to the private account plan.

Figure 1

The Increase in Federal Debt is Large and Lasting



Source: Center on Budget and Policy Priorities and Joint Economic Committee Democratic Staff.

twenty-year increase in debt would exceed $5 trillion. Adding price indexing to the plan would do little to offset the increase in debt. Debt would still grow by close to $5 trillion over the first twenty years.

The increase in government debt lasts indefinitely. These increases in debt are not simply transition costs that go away. Debt would increase rapidly relative to the size of the economy, reaching 35 percent of GDP by 2060 **(Figure 1)**. Federal debt held by the public was 37 percent of GDP at the end of 2004.[9] Thus the increase in the debt from private accounts is about the same size as the existing level of debt today (relative to GDP). If existing federal debt stays at its current level relative to the economy, adding the additional debt from the President's private account plan would increase federal debt to over 70 percent of GDP.

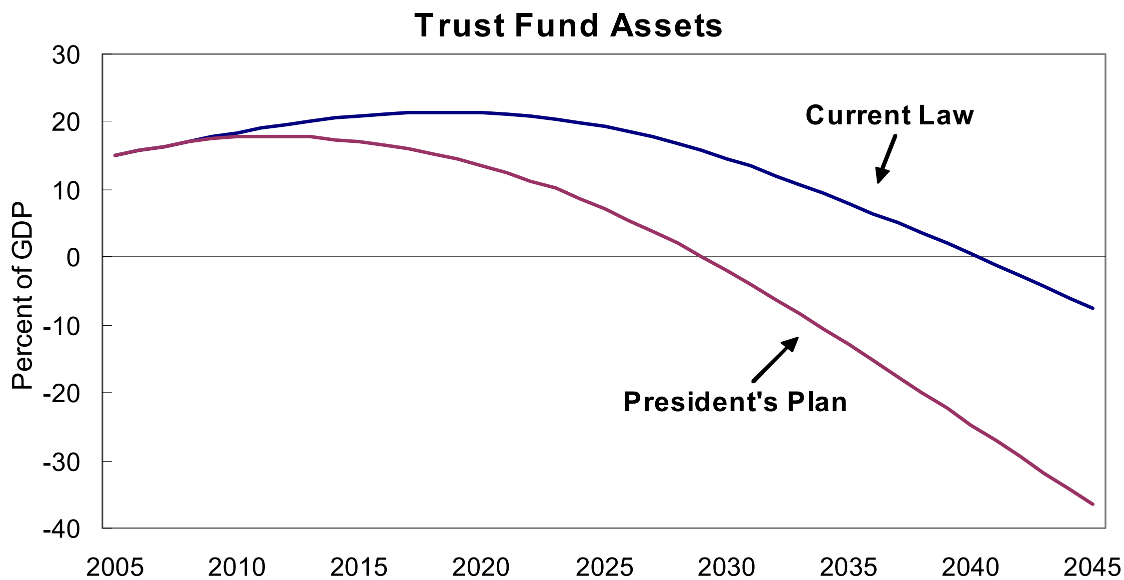
The additional debt is never fully paid off. Because payroll taxes are diverted to private accounts, the government must borrow money to pay current Social Security benefits. The sum of that borrowing and associated interest is the gross cost. Eventually, when people retire, they will repay Social Security (through cuts in their guaranteed benefits) the amount of payroll taxes diverted to private accounts plus the interest the Trust Fund would have earned on those contributions. The net cost to the government is the gross cost minus the amount paid back (the "privatization tax").

Because the interest rate used to calculate the privatization tax is set equal to the interest rate the government pays when it borrows, the average amount that individuals pay back (with interest) eventually fully covers the government's cost. However, because there are always more working-age people (diverting payroll taxes to private accounts) than there are retired people (paying back the privatization tax), the annual net cost to the government never goes to zero.

We are not borrowing now to save more in the future. The Administration and other supporters argue that the additional debt is not a problem because we would simply be trading explicit debt for the implicit future debt that comes from promised Social Security

Figure 2

President's Plan Would Deplete the Social Security Trust Fund by 2030



Source: The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, Center on Budget and Policy Priorities, and Joint Economic Committee Democratic Staff.

benefits that exceed projected Social Security revenues. That is wrong for at least two reasons.

First, the President's private account plan does nothing to address Social Security's unfunded liabilities.[10] As discussed in the next section, it will actually weaken long-term solvency. As a result, private accounts will incur explicit debt today and create even higher implicit future debt than we have now.

Second, even if there were a private account plan financed by borrowing that did actually reduce future unfunded liabilities, it seems clear to most Wall Street observers that financial markets do not treat explicit debt the same as implicit debt. When explicit debt is due it must be paid off or refinanced. Implicit debt can be met by changing future benefits or future revenues. If financial markets really did view future unfunded liabilities as equivalent to actual government debt, interest rates would be much higher today.[11]

Private Accounts and Social Security Solvency

The President's plan for private accounts would worsen Social Security solvency. In the short term, less money coming into Social Security will weaken the solvency of the Trust Fund. The Trust Fund will lose about $4.9 trillion in trust fund assets in the first twenty years the plan is in effect. The date the Trust Fund can no longer pay full benefits will move up by about 11 years from 2041 to 2030 **(Figure 2)**.

Over time, the Social Security Trust Fund would recoup the diverted payroll taxes plus interest, through the privatization tax, which would cut guaranteed benefits to workers who chose private accounts. The interest rate would be set at 3 percent above the rate of inflation—the same rate that the Social Security Trustees project the Trust Fund would earn on government bonds.

Table 2

President's Private Accounts Would Increase the Social Security Shortfall

	Present Value Over 75 Years (2004-2078)			
	(trillions of dollars)		(percent of GDP)	
Current Social Security Shortfall (SSA estimate)		-4.0		-0.65
President's Plan for Private Accounts				
Cost of Revenues Diverted to Accounts	-4.7		-0.76	
Privatization Tax on Account Holders	3.1		0.51	
Net Cost of Private Accounts	-1.6		-0.25	
Current Social Security Shortfall Plus Private Accounts		-5.6		-0.90
Possible Additional Cuts in Traditional Benefits				
Price Indexing	4.8		0.78	
Current Social Security Shortfall Plus Private Accounts and Price Indexing		-0.8		-0.12

Source: Center on Budget and Policy Priorities and Joint Economic Committee Democratic Staff.

As long as the benefit reduction for each worker fully matches the payroll taxes diverted to a private account plus the associated interest cost, Social Security would be held harmless over the long-term. However, it is unlikely that this will happen in every case. Social Security will not recoup lost revenues from workers who die before retirement unless their survivors are forced to receive reduced benefits. If the returns on investments in private accounts do not match the amount of the cut in guaranteed benefits, there will be pressure to offset that investment loss by reducing the benefit cut.

Moreover, over any particular length of time, the private accounts plan would increase the Social Security shortfall because more money would be diverted to private accounts than would be recouped through the tax on guaranteed benefits.

The Social Security Trustees estimate that the present value of the shortfall over the 75-year planning horizon typically used for Social Security is $4.0 trillion. "Present value" expresses a stream of surpluses or deficits over many years as a single number. It is the amount of money needed today to cover the shortfall over the next 75 years. The SOTU plan would increase the present value of the Social Security shortfall by $4.7 trillion over the next 75 years **(Table 2)**. The reduction in guaranteed benefits would recoup about $3.1 trillion over the same period, leaving a net increase in the shortfall of $1.6 trillion.

Adding price indexing to the SOTU plan would cut guaranteed benefits by $4.8 trillion in present value over the next 75 years – enough to more than eliminate the current shortfall, but not the current shortfall plus the additional deficit from private accounts.

Private Accounts and National Saving

The President's plan for private accounts will not increase national saving, and is more likely to cause national saving to fall. National saving is the key to future growth and preparing adequately to absorb the budget pressures from the retirement of the baby boom generation. National saving is the means of financing new investment in plant and equipment, research and development, and other investments that contribute to economic growth and a rising standard of living.

Investment can grow for a time without additional national saving if we are able to borrow from abroad. Eventually, however, we must pay back what we borrow. Most of the additional growth from investment financed by foreign borrowing is returned to our creditors and does not contribute to an increase in the future U.S. standard of living. Moreover, borrowing from foreigners may not be sustainable, and when it stops, there can be severe disruptions to international financial markets and the to the U.S. and world economies.

National saving has two components: private saving by households and businesses, and public saving by the federal government and state and local governments. The establishment of private accounts would raise private saving, but the borrowing necessary to fund those accounts would reduce government saving by the same amount. The initial effect would be a wash. It would be like an individual borrowing from a home equity line of credit to establish a retirement savings account.

In fact, however, the net impact of private accounts on national saving is likely to be negative. To the extent that workers view the money in their private accounts as new saving, they may decide to contribute less to their 401(k)s, IRAs, or other existing savings accounts. Moreover, as has been the case with IRAs and 401(k)s, there will probably be political pressure to allow workers to tap into their private accounts early for certain medical or other emergency expenses. If some of the new saving in private accounts is offset by a reduction in other private saving, the net increase in private saving will be smaller than the reduction in public saving, and national saving will go down.

Conclusion

The President's plan for private accounts would lead to a massive increase in federal debt, worsen the solvency of Social Security, and not increase national saving. If the benefit cutbacks President Bush seems to favor were added to the plan, future generations would face large cuts in their guaranteed Social Security benefits that they most likely would not be able to offset with earnings from their private accounts.

(Endnotes)

[1] E-mail from Peter H. Wehner, "Some Thoughts on Social Security," Jan. 3, 2004; Jonathan Weisman and Mike Allen, "Social Security Formula Weighed; Bush Plan Likely to Cut Initial Benefits," The Washington Post, Jan. 4, 2005, p. A1.
[2] *The 2005 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, Table VI.F10, p.186.
[3] The PCSSS plan would also increase benefits for some low-wages workers and some widows and widowers.
[4] Social Security Administration, Memorandum Re: Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security, Jan. 31, 2002, p. 75. Wall Street economists recently pointed out that as a result of price indexing, "Social Security benefit payments would eventually become so small as a share of the overall economy as to be largely irrelevant." Goldman Sachs, *Thoughts on Social Security Reform* (Jan. 18, 2005), p. 20.
[5] Congressional Budget Office, *Long-Term Analysis of Plan 2 of the President's Commission to Strengthen Social Security* (updated September 30, 2004), Tables 2 and A-2.
[6] Id.
[7] Id.
[8] The Administration admits that the plan will cost far more. See Christopher Lee, "Cheney: Social Security Plan to Cost Trillions," The Washington Post, February 7, 2005, page A02.
[9] Congressional Budget Office. *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, January 2005. Table 1-5, p. 20.
[10] The Administration also admits this. As stated in the E-mail from the White House Director of Strategic Initiatives Peter Wehner, "If we borrow $1-2 trillion to cover transition costs for personal savings accounts and make no changes to wage indexing, we will have borrowed trillions and will still confront more than $10 trillion in unfunded liabilities." "Some Thoughts on Social Security," Jan. 3, 2004.
[11] At a minimum, it would be very risky to assume that financial markets would not react to the huge increase in federal debt. At a hearing held by the Senate Committee on Banking, Housing, and Urban Affairs on February 16, 2005, Federal Reserve chairman Alan Greenspan observed "First, we don't know the extent to which the financial markets at this stage, specifically those trading in long-term bonds, are discounting the…contingent liability that we have. …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."