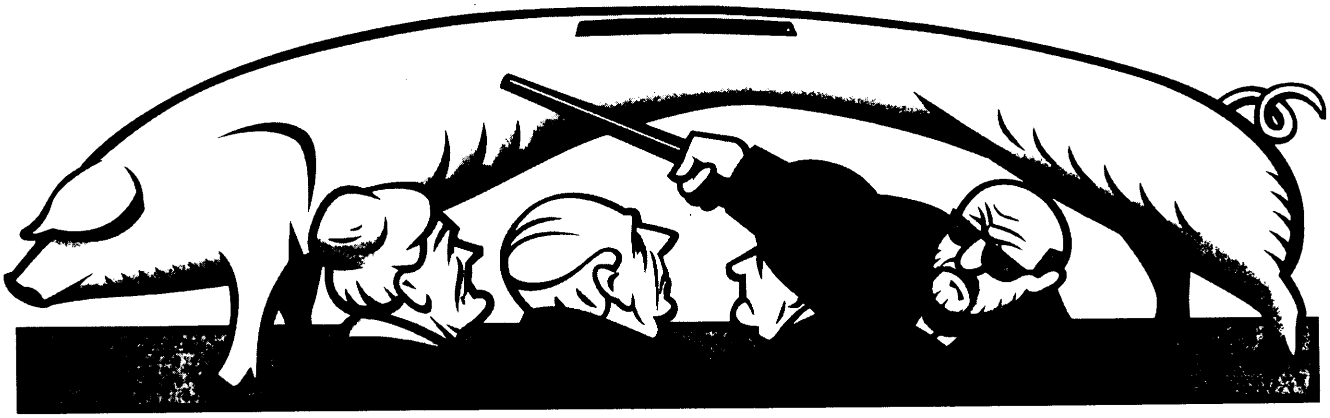

America's golden opportunity

WASHINGTON, DC

With a budget in surplus, America has an unprecedented chance to reform its pensions system. Here, says Martin Feldstein, is what it should do

THE reform of the Social Security pension programme is the most significant economic-policy issue facing the United States. Government actuaries project that within a dozen years the retirement benefits mandated by current law will exceed Social Security payroll taxes. With the existing pay-as-you-go method of financing, the long-term ageing of the population will make the situation worse: to cover the cost of projected benefits, the Social Security payroll tax, currently 12.4%, will have to rise to more than 19%. Clearly, this problem will have to be resolved somehow. Exactly how it is resolved has enormous implications for national saving and future tax burdens as well as for the well-being of the aged.

The budget surpluses forecast for the next 25 years grant a unique opportunity to devise a solution that maintains current benefits without higher taxes. The key is to use part of the surpluses to fund a new system of personal retirement accounts, invested in a mixture of stocks and bonds. Funding such accounts is economically equivalent to paying down the national debt—and is politically far more reliable as a way of preventing budget surpluses from being spent on other things. This accumulation in personal retirement accounts is new national saving that increases the nation's capital stock. My calculations (summarised below) show that depositing about 2% of wages in such accounts each year would meet the cost of currently projected benefits for ever, without any increase in the payroll tax.

The plan that President Clinton proposed in his recent state-of-the-union message fails to grasp this opportunity. It does not protect benefits permanently or prevent future tax increases. It makes no fundamental changes in either the benefit rules or the financing of Social Security. Instead it "guarantees" benefits for an additional 20 years by issuing new government bonds to the Social Security trust fund. Redeeming those bonds in the future would in practice require raising income taxes or incurring future budget deficits.

The president would also swap about $1 trillion of government bonds over the next 15 years for corporate stock in order to raise the rate of return on the Social Security trust fund—an idea that congressional leaders correctly rejected as entailing unacceptable political interference in the private economy. Mr Clinton's related proposal to contribute government funds to new individual saving accounts remains vague, but is explicitly separate from Social Security reform.

Finally, although the president claims that his proposal would use a large part of the projected budget surpluses to pay down the national debt, there is nothing in his plan to make that happen. Before examining how to use such surpluses to prefund future Social Security benefits, consider what would happen if the pay-as-you-go system stays. The ageing of the population will reduce the number of workers per retiree from about three today to about two within 30 years. With one-third fewer workers per retiree, an unchanged tax rate implies that benefits must be cut by one-third. Alternatively, unchanged benefit rules would require raising the Social Security tax rate, as already indicated, from today's 12.4 % to more than 19%.

How the plan would work

The Social Security trust fund holds the present surplus of payroll-tax receipts over benefits in the form of government bonds, but this is a mere accounting convention: it does not affect the fundamental arithmetic. When annual benefits come to exceed payroll tax receipts, as they are expected to by 2012, those bonds will be sold to the public, crowding out private borrowing and investment. When the trust fund has sold all its bonds, which it is currently projected to do in 2032, the government will be forced to raise the payroll tax, cut benefits or turn to other sources of revenue.

Mr Clinton's plan to award new bonds to the trust fund is in effect a promise that, when the traditional trust fund bonds are gone, the government will raise taxes or borrow to keep the money flowing to Social Security retirees. The fundamental point is this: the ageing population is an inescapable fact that, in combination with pay-as-you-go financing, will require higher taxes to prevent benefit cuts or budget deficits. In contrast, a mixed system that combines traditional pay-as-you-go financing with investment-based accounts can permanently avoid higher taxes while continuing to pay the benefits promised in current law.

Here is how one such mixed system could work. If you are an employee or self-employed, you select a fund manager (such as a bank or mutual-fund company) and one or more specific stock or bond funds offered by that firm. You write the identification numbers of that firm on your personal tax return. You and your employer continue to pay a combined 12.4% payroll tax. But in addition the government deposits 2.3% of your previous year's wages (up to the Social Security taxable maximum, now $72,600) into your Personal Retirement Account (PRA). If you do not select a fund manager, the government opens an account for you with a private fund manager or a government entity like the Federal Thrift Saving Plan.

When you reach retirement age, your PRA balance is used to buy an annuity based on stock and bond investments. You receive both traditional tax-financed benefits and the PRA annuity. The government guarantees that this combination is at least as large as the benefit that you are promised in current law. That guarantee would extend to spouses and other dependants of retirees and of deceased workers.

In the scheme I propose, 75% of the PRA annuity would be used to help finance your Social Security benefit while the remaining 25% would be extra retirement income. For example, if you were entitled to a Social Security benefit of $1,300 a month under current law and your monthly PRA annuity is $800, you would receive a total of $1,500 a month under the new scheme—the promised $1,300 from Social Security plus 25% of the $800 PRA annuity. Equivalently, you could regard this as receiving the $800 PRA annuity in full, while the Social Security benefit becomes $700.

The important point is that you receive $1,500 while the net cost to the Social Security pay-as-you-go financing is only $700, since $800 comes from the PRA annuity. Because that $700 is substantially less than the $1,300 promised benefit, the future payroll tax can remain at 12.4% instead of rising to more than 19%. The size of the PRA annuity reflects the return on a mixture of stocks and bonds. A portfolio of 60% stocks (the S&P 500) and 40% corporate bonds earned a real average return of 5.9% from 1946 to 1995. Subtracting administrative costs of 0.4% leaves a usable return of 5.5%. With this return and the demographic and economic projections of the Social Security Administration, the combination of the PRA annuities funded with 2.3% of taxable wages and the current 12.4% payroll tax would be enough to pay the promised benefits for at least the next 75 years—as far into the future as the Social Security projections allow us to look.

From here to there **1**

% of taxable wages

	Present system: Payroll tax under pure pay-as-you-go	Proposed system: Aggregate PRA annuities	Proposed system: Net pay-as-you-go financing requirements
2010	12.2	0.1	12.1
2030	17.8	2.5	15.4
2050	18.7	7.7	12.9
2075	19.8	10.7	11.8

Notes:
Column 1 presents the payroll tax rate that would be needed to finance benefits in a pure pay-as-you-go system. Column 2 shows the PRA annuities as a percentage of taxable wages. Subtracting 75% of the annuity gives the net required amounts shown in column 3. When this amount exceeds the 12.4% payroll tax, the remaining gap is filled by trust fund interest receipts and bond redemptions.

Source: National Bureau of Economic Research

Table 1 shows how the projected PRA annuities reduce the need for pay-as-you-go taxes in selected future years. In 2075, for example, when the pure pay-as-you-go system would require a payroll tax rate of 19.8%, the mixed system would require a payroll tax of less than the current rate. The government's PRA deposit of 2.3% of earnings (equal to 0.9% of GDP) can easily be financed with future budget surpluses. The Congressional Budget Office (CBO) projects that the budget surplus will rise from 1.4% of GDP in 2000 to 2.8% in 2009, will remain above 1% of GDP until after 2020, and then turn into a deficit at some time between 2020 and 2030.

By 2030, however, the PRA system would be self-financing. The growth of the PRA balances results in higher national income and higher corporate-tax revenues, as shown in Table 2. The figures show that even if the surpluses ended abruptly in 2020, the increase in corporate-tax revenue would finance all but an average of 0.5% of GDP between then and when the system becomes self-financing in 2030.

Specific features of the PRA plan could be modified if there were a political will to do so. For example, increasing the retirement age or decreasing the inflation-indexing of benefits, as some congressional plans propose, would permit retirees to keep more than the 25% of PRA annuities, or would lower the 2.3% PRA saving rate. Individuals who die before they are 65 could bequeath their entire accumulated PRA balance if the 2.3% PRA deposits were increased to 2.6% of taxable earnings.

It pays for itself **2**

% of taxable earnings

	PRA assets	Increase in GDP	Additional corporate tax
2010	30.2	2.58	0.65
2030	112.8	9.60	2.40
2050	183.5	15.60	3.90
2075	199.8	16.98	4.24

Notes:
All figures have been restated as a percentage of taxable earnings. Column 1 shows the additional national capital that results from the PRA accounts. An 8.5% real pre-tax return on incremental capital (the average for the past 40 years) implies the additional national income shown in column 2. An effective tax rate of 25% (about two-thirds of the statutory corporate tax) gives the additional tax revenue shown in column 3. By 2030 this incremental revenue is 2.4% of taxable earnings, enough to fund the 2.3% of payroll PRA deposits.

Source: National Bureau of Economic Research

Federal Reserve Chairman Alan Greenspan and others have stressed the favourable effects of using budget surpluses to pay down the national debt by redeeming outstanding government bonds. In this way the surpluses would add to national saving and permit increased investment in equipment and structures. The smaller national debt would also reduce future interest payments, permitting lower future taxes.

Protecting the surpluses

The practical problem is to prevent politicians from using these surpluses for other purposes. Mr Clinton emphasised the desirability of preserving future surpluses—and simultaneously proposed increased spending on Medicare, defence, education, police, and so forth. During the past 15 years, the Social Security programme had surpluses every year: they were used to fund other government spending, not to pay down national debt. A law to put Social Security "off budget" was enacted but proved ineffective because the political process concentrates on the overall budget balance. Current proposals to change government accounting to hide the surpluses from politicians are unlikely to be any more successful.

A principal virtue of my proposal is that the funds deposited by the government in the PRA would be outside the government budget. Those deposits would be counted as government outlays, reducing the budget surplus and eliminating the temptation for politicians to increase other spending. The PRA deposits would add directly to national saving.

Indeed, if the PRA balances were invested in government bonds, the entire transaction would be essentially equivalent to using that part of the budget surpluses to pay down national debt. The government bonds would be held in the PRAs but 75% of those bonds and the accumulated interest would eventually revert to the government to help finance Social Security benefits. Investing in private securities rather than government bonds provides a higher expected return. Those who favour using the budget surpluses to reduce the national debt should prefer the PRA plan as a politically more realistic way to achieve the same goal.

Critics of individual accounts often cite a misleading CBO study of the proposed use of budget surpluses to fund PRA-type accounts. Following the traditional CBO procedure, the study assumes that the alternative to the PRA accounts would be the "current law", that is, no change in spending or taxes. The budget surpluses would therefore be fully saved and any alternative policy, including the PRA plan, would reduce saving relative to this baseline. The study is misleading because it assumes a very implausible political response to sustained budget surpluses. The CBO notes that the PRA-type accounts would actually raise national saving if the budget surpluses would otherwise be spent.

PRA investments in stocks and bonds provide a higher expected return than investments in government bonds without the disadvantages of direct government ownership. Despite the president's claim that the government could own shares without political interference, few believe this. Congress would be tempted to exclude certain kinds of companies from the portfolio (cigarette manufacturers, firms doing business with embargoed countries, and so on), to invest more heavily in firms that already receive favourable treatment in other government programmes, and to interfere in takeover battles and other proxy issues. Politically motivated investment decisions would lower the portfolio return and extend meddling by government in the private economy.

Another criticism of PRA-type plans is that they expose retirees to financial-market risk. Under my proposal, the government guarantees that each retiree's combined benefits would be at least as large as under current law. Individuals are at risk only with respect to how much extra retirement income they might receive from their PRA annuity.

A more subtle and legitimate concern is about the risk to future taxpayers implicit in providing that guarantee. I have analysed this risk on the basis of the past volatility of stock and bond prices. During the first few decades of the mixed system there would be virtually no risk to taxpayers because the aggregate value of the PRA annuities would be relatively small. But even after 75 years, there is less than one chance in a hundred that the government guarantee payment in any year would be as large as 5% of taxable wages. If it were to happen, combining this 5% with the 12.4% payroll tax would still leave a total burden that is less, in the year concerned, than the long-term 19.8% tax under pay-as-you-go.

Opponents of individual investment-based accounts sometimes argue that administrative costs would destroy much of the gain. This ignores the fact that the American mutual-fund industry already provides individual accounts at a cost of less than 0.25%. The experience of TIAA-CREF, the largest American provider of pensions, indicates that annuitisation at retirement would involve no extra costs. Direct government deposits into the PRAs eliminate the main administrative expense of collecting funds. The primary driver of costs will be the services and information that fund managers provide to participants. Improvements in telecommunications and computing are already reducing such costs very quickly.

Redistribution preserved

The primary concern of many who oppose individual investment-based accounts is the fear of undermining the redistribution that is built into the existing programme. Even with the guarantee that every retiree would get at least as much in the mixed system as they would under today's rules, they dislike the fact that the additional PRA annuity income would be proportional to past earnings rather than following Social Security's redistributive relation between earnings and benefits. This seems to me a misplaced concern. The pay-as-you-go portion would continue to finance about two-thirds of aggregate benefits and could be designed to provide whatever overall redistributive pattern Congress wants.

Also, the PRA plan would benefit many lower-income employees who are not well served by current Social Security rules. For example, since Social Security benefits are now based on the individual's highest 35 years of earnings, someone who starts work at 17 and retires at 67 gets no return on 15 years of tax payments. In a PRA in which the deposits for those 15 years grow at 5.5% a year in real terms for about 50 years, each initial dollar of deposit would increase to about \$14—implying that someone earning \$25,000 a year during those 15 years would receive an additional \$30,000 in retirement income.

But the most important distributional consequence of the PRA system would be in reducing future taxes on low- and middle-income employees. Avoiding an increase in the payroll tax from 12% to 19% is equivalent to about a 10% increase in spendable income for individuals with earnings up to \$70,000, and relatively smaller increases above that level. I can think of no government policy that would have such a beneficial effect on low- and middle-income employees.

The PRA system is not a free lunch or a costless way to solve the serious problems of Social Security. Maintaining future benefits without raising future taxes requires saving budget funds over the next 30 years that could otherwise be used to finance immediate tax cuts or increased government spending. There is no magic in this solution. It reflects the productivity of increased real investment. The fundamental tradeoff—investing about 2% of taxable wages for the next 30 years in order to keep taxes permanently lower by 7% of taxable wages—is an extremely attractive option. The projected budget surpluses make it possible to do this without the politically difficult task of raising taxes or cutting existing spending.

Mr Clinton's state-of-the-union message contains all the building blocks of a system of individual investment-based accounts: using future budget surpluses to maintain Social Security benefits, investing in equities, and putting government funds into individual accounts. Although the form in which the president combines these building blocks is mistaken and dangerous, they provide the basis for serious negotiations. This unique opportunity to protect retirement incomes and prevent a large and permanent increase in taxes should be seized before it is too late. ■