

Protecting Retirement Incomes

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Summary: Combining an investment based system of Personal Retirement Accounts with the traditional tax-financed Social Security can eliminate the need for any increase in the payroll tax or decrease in Social Security benefits. The required PRA deposits of 2.3 % of covered earnings could be financed by the projected budget surpluses and by the future increases in corporate tax revenue that result from PRA saving.

The Problem of Increasing Social Security Costs

Under current law, Social Security benefits (OASDI) will rise from about 12 % of covered payroll now to about 18% in 2030 (and will then keep rising).

The cause of this rise is increasing life expectancy, not just the baby boomers. The proportion of the population over age 65 will rise from 12 percent now to 20 percent in 2030.

The tax increase or the reduction in retirement incomes that would be inevitable with the current “pay as you go” system could be avoided completely by shifting in part to an investment-based system.

The projected budget surpluses provide an opportunity to do this without imposing new burdens on current employees or reducing benefits of retirees.

Investing Retirement Funds in Stocks and Bonds

A large number of American employees now invest in stocks and bonds through IRAs and 401k plans.

The idea of combining traditional pay-as-you-go Social Security with investment-based individual accounts was supported by a majority of the 1996 Quadrennial Social Security Advisory Council.

Many countries around the world have adopted such systems, including the UK, Australia, Sweden, Italy and several in Latin America.

These plans all feature increased national saving, invested in financial assets through individual accounts.

A Personal Retirement Account (PRA) Plan¹

The government would put 2.3 percent of last year's taxable wage (up to the Social Security maximum, now \$72,600) into a new Personal Retirement Account that individuals could invest in stock and bond mutual funds.

In effect, the individual gets a tax cut of 2.3 percent of payroll (up to \$1670), with the tax cut deposited in the PRA. The PRA deposit is thus free to the individual. .

The PRA deposits cost about 0.9% of GDP and can be financed with the projected budget surpluses.(CBO projects surpluses of 1.4% in 2000, 2.8% in 2009 and more than one percent until after 2020). Eventually the extra corporate tax revenue resulting from additional capital accumulation could finance the PRA deposits.

Combining the PRA and Traditional Social Security Benefits

When the individual reaches retirement age, the PRA balance is used to finance an annuity based on stock-bond investments.

The individual receives a combination of traditional tax-financed Social Security benefits and of the PRA annuity. The combination is guaranteed to be at least as large as the benefits projected by current law.

More specifically, the government pays each retiree the amount specified in current law reduced by 75 percent of the individual's PRA annuity.

If current law benefits are \$1000 and the PRA annuity is \$600, the individual gets \$1150 but the cost to Social Security is only \$550.

What a 2.3 percent of payroll PRA means for future Social Security financing

A portfolio of 60 percent stocks and 40 percent bonds earned a real 5.9 percent from 1946 through 1995. Subtracting administrative costs of 0.4 percent leaves a usable real return of 5.5 percent.

Using calculations based on demographic and economic projections of Social Security Administration, and assuming the 5.5 percent real return implies:

By 2030, PRA annuities would be 2.5% of payroll, reducing the required payroll tax by 1.91 percent of payroll.

By 2050, PRA annuities would be 7.7 % of payroll, reducing the required payroll tax by 5.74

¹More details about this plan are provided in the attached paper, "Maintaining Social Security Benefits and Tax Rates through Personal Retirement Accounts: An Update Based on the 1998 Social Security Trustees Report" by Martin Feldstein and Andrew Samwick.

percent of payroll.

By 2075, PRA annuities would be 10.7 % of payroll, reducing the required tax by 8.03 percent of payroll, from the projected 19.8 percent to 11.8 percent.

Would the PRA accumulation raise national saving?

Yes, if the projected budget surpluses would otherwise be used to increase government spending or to finance tax cuts that cause household spending to rise.

If the projected surpluses would otherwise be used exclusively to reduce the national debt, the PRA plan would have no direct effect on national saving.

Table 1

	<u>Effects of PRA Deposits and Annuities on Social Security Outlays</u>				
	PRA Deposits	PRA Annuities	PRA Annuities	Social Security Outlay Reductions	Social Security Trust Fund
	(\$ Billion*) (1)	(\$ Billion*) (2)	(% of Earnings**) (3)	(% of Earnings**) (4)	(% of Earnings)
2000	81.15	0.00	0.00	0.00	25.45
2010	94.21	5.87	0.14	0.10	41.33
2020	106.05	40.88	0.89	0.67	43.85
2030	116.78	129.11	2.54	1.90	25.31
2040	130.66	273.01	4.80	3.60	4.36
2050	144.62	481.27	7.65	5.74	3.13
2060	159.23	690.07	9.97	7.48	19.38
2075	184.16	857.01	10.71	8.03	55.16

*Billions of dollars at the 1998 price level.

** Percentage of Aggregate Covered Earnings

Table 2

	<u>PRA Assets and Increases in GDP and Corporate Tax Revenue</u>					
	<u>PRA Assets</u>		<u>GDP Increase</u>		<u>Corporate Tax Increase</u>	
	(\$ Billion*)	% of GDP**	\$ Billion*	% of GDP**	\$ Billion*	% of GDP**
	(1)	(2)	(3)	(4)	(5)	(6)
2010	1239.7	12.1	105.3	1.03	26.3	0.26
2020	3140.8	27.2	266.9	2.31	66.7	0.58
2030	5728.4	45.1	486.9	3.84	121.7	0.96
2040	8679.7	61.1	737.8	5.19	184.4	1.30
2050	11542.2	73.4	981.1	6.24	245.3	1.56
2060	13722.0	79.3	1166.4	6.74	291.6	1.68
2075	16001.1	79.9	1360.1	6.79	340.0	1.69

* Billions of 1998 Dollars
** Percent of Baseline GDP forecasts