

## Saving Social Security

By Martin Feldstein

A recent proposal by House and Senate Republicans marks the start of the legislative process to implement President Bush's approach to Social Security reform. The fundamental principle is to supplement traditional pay-as-you-go Social Security with investment-based personal retirement accounts. Although the new congressional plan is not a complete solution to long-run problems, it's an excellent starting point. By using the Social Security surpluses that are projected between now and 2017, it lays the foundation for personal retirement accounts without diverting the payroll tax needed to fund current benefits.

Adding voluntary savings through salary deductions to these personal retirement accounts would substantially strengthen this reform. After the Social Security surpluses end in 2017, a voluntary savings plan would continue to add to personal retirement accounts, providing a more secure future retirement. The key to the success of such a voluntary add-on plan is to combine automatic enrollment with the ability of each individual to opt out if he or she does not want to participate. Experience with the 401(k) plans of private firms shows that this combination of automatic enrollment with the right to opt out leads to participation rates of 80% or more even when there are no employer matching contributions.

When employees are given the choice of whether to participate in a corporate 401(k) plan, it is common for fewer than half to sign up. But when told that the company will deduct some amount from their pay and deposit it in a 401(k) plan, the participation rate jumps to 80% or more even though they have the right to opt out and keep their full earnings. Experience shows that the "default option" -- whether you are automatically in unless you decline, or automatically out unless you enroll -- has a powerful effect on what individuals choose to do.

The basic congressional Republican proposal should be modified to incorporate automatic enrollment in voluntary saving accounts. The ability to opt out would permit each employee to decide on a year-by-year basis whether he wanted to add to his personal retirement account or receive the income in cash. Once funds were committed to the account, they would remain until the individual reached retirement age. Those who die before retirement age would bequeath their accumulated balance to their spouse or other heirs.

This is not about privatizing Social Security. The current Social Security tax rate would be unchanged and continue to finance traditional pay-as-you-go benefits. The personal retirement accounts would not replace traditional Social Security but would supplement the more limited pay-as-you-go benefits that would result as the aging of the population leaves fewer workers per retiree. The voluntary additions to these accounts would mean greater retirement income.

The automatic enrollment feature would also increase national saving, a high priority in its own right. A higher national saving rate would finance investment in plant and equipment that raises productivity and produces the extra national income to finance future retiree benefits. A higher national saving rate would also reduce dependence on capital from abroad and would therefore shrink our trade deficit.

Here's how the combination of the congressional Republican plan and the voluntary automatic enrollment accounts would work. Today's surplus Social Security dollars are transferred to the government's general budget and used to finance a whole range of other government activities. The proposal would stop this use of surplus dollars by putting them into personal retirement accounts. The total surplus available for each year would determine the percentage of earnings (up to the maximum amount taxable for Social Security) that would go into each individual's account.

Each employee, regardless of marital status, would have his or her own lifetime account. These funds would initially be invested in government bonds but after 2008 could be shifted into broadly diversified stock and bond mutual funds monitored by an independent government agency. The voluntary automatic enrollment plan would supplement these surplus funds and make personal retirement accounts a permanent feature of retirement income. For example, with a 3% automatic enrollment plan, employers would subtract 3% of each individual's earnings (up to the maximum amount taxable for Social Security) and forward those dollars to the Social Security Administration along with the regular Social Security payroll taxes. These voluntary savings would come from income before tax and the balances in the personal retirement accounts would accumulate tax free, just as in an IRA or 401(k).

The Social Security Administration would then transfer the voluntary savings deposit together with the surplus fund amount into the individual's personal retirement account. Although the annual participation would be automatic, the individual could indicate on his tax return in the next year that he does not want to participate for that year, causing the 3% amount to be refunded to the individual.

The aging of the population means that the existing pay-as-you-go Social Security program cannot by itself provide adequate retirement incomes without a very large increase in the payroll tax rate. Fortunately, such a tax increase can be avoided. Supplementing the traditional pay-as-you-go benefits with investment-based personal retirement accounts financed by a combination of the projected surpluses and voluntary automatic savings would eliminate the need for any rise in Social Security taxes while providing a secure source of income for future retirees.

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