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COMMENTARY

Fact vs. Fancy: The Skinny on Social Security

By MARTIN FELDSTEIN

Reforming Social Security finances is the major domestic challenge that the president will face in the next four years. Without reform, the aging of the population will eventually mean a major cut in benefits or a large tax increase. When today's 40-year-olds are retired, benefits would have to be cut by one third or the payroll tax rate increased from today's 12.4% to more than 18%. And that wouldn't begin to deal with the rising cost of Medicare. It is important, therefore, to ask how each candidate would deal with Social Security.

In his 2000 campaign for the presidency, George Bush laid out an approach to maintaining Social Security retirement income without raising taxes. He repeated that proposal in his State of the Union address and in a speech just last week. The basic Bush strategy is to permit individuals to augment their traditional tax-financed Social Security benefits with funds accumulated in an investment-based personal retirement account (PRA). In adopting such a mixed plan, the U.S. would follow investment-based strategies of several countries including Australia, Britain and Sweden.

The PRA assets would be invested in a mixture of broad-based stock and bond mutual funds. When the individual retires, the PRA assets could be used to purchase an annuity. The combination of those annuity payments and the traditional Social Security benefits that could be financed without increasing the current tax rate would be expected to be at least as large as the benefits projected in current law. In short, there would be no cut in the expected combined retirement benefits and no increase in taxes. Moreover, for current retirees and those who will soon be 65, there would be no change at all in the Social Security program.

When he became president, Mr. Bush appointed a bipartisan commission to examine how his strategy could be made operational. They concluded that there are a variety of feasible alternatives. Unfortunately, the focus turned to national security after 9/11, tax policies to stimulate economic recovery, and Medicare reform, keeping Social Security on the legislative back burner. But the president's recent speech made it clear that Social Security reform along the lines of his basic strategy would be a priority in his second term.

Although John Kerry has not laid out a plan to reform Social Security or to solve its fiscal problems, he has given some indication of how he might cut Social Security benefits. In a speech in Ohio and on the Kerry-Edwards Web site, Mr. Kerry has said that he would consider "making sure that high-income beneficiaries don't get more out than they pay in" as taxes during their working years. In practice, the Kerry plan would mean cutting Social Security benefits by about 80% for those whose

benefits are reduced.

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Here's why: The Social Security payroll tax is paid on income up to a limit -- currently \$87,900 -- that rises annually with overall wage growth. Individuals and employers now each pay a 5.3% tax for Social Security retirement benefits, with a maximum individual tax payment in 2004 of \$4,659. Additional payroll taxes are paid for Medicare and disability insurance.

Anyone who turns 65 this year and who has always paid the maximum Social Security tax would have paid total taxes from age 21 to 65 of \$82,066. Such a new retiree would now be entitled to annual benefits of about \$22,000, an amount that would rise with the price level. With an expected remaining life of 17 years and a 2% inflation rate, this retiree would receive \$440,000 by age 82. To limit the expected benefit to the \$82,066 paid in lifetime taxes, the Kerry plan would require cutting the benefit by 80%. The annual benefit would fall from \$22,000 to only \$4,100.

Mr. Kerry has not said which "high income" retirees would be hit by these drastic cuts. If it is limited to the same top 3% of income earners as the \$200,000-plus group that Mr. Kerry has targeted for an income tax increase, the number of individuals and the cut in total Social Security outlays would be very small. Even the 80% cut in benefits for that group would reduce total Social Security outlays by less than 5%. A benefit cut targeted in that way would be more of a gesture against high earners than a serious attempt to reduce Social Security's fiscal shortfall.

It would, moreover, be unfair to cut the benefits by 80% for someone who earns \$200,000 and not to cut the benefits of someone who makes only slightly less. What logic could there be to cutting the benefits of those who had preretirement incomes over \$200,000 to \$4,100 a year while still paying benefits of \$22,000 a year to someone with a pre-retirement income of \$190,000? Moreover, if increasing preretirement earnings from \$190,000 to \$200,000 a year caused an individual to lose nearly \$18,000 a year in retirement benefits, there would be a strong incentive to work less or to receive more potential income in the form of untaxed fringe benefits. The Kerry benefit cut therefore could not be just for those with very high incomes but would have to be phased out gradually at lower incomes.

Mr. Kerry should explain how far down the income distribution he would apply his proposed benefit cut. There are two clues to his thinking on the Kerry-Edwards Web site. We are told there that Mr. Kerry will not "cut benefits for people that rely on Social Security." Since more than a third of the labor force participate in 401k plans with more than \$1.5 trillion in assets and tens of millions have IRAs with more than \$2.5 trillion in assets, Mr. Kerry could cut benefits for a large number of middle-class individuals who do not "rely on Social Security."

The Kerry Web site also emphasizes that "current law revenues would be sufficient to pay 73% of scheduled benefits after trust fund exhaustion in 2042." So is Mr. Kerry willing to accept an expected benefit cut of 27% for all future retirees?

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If that's the plan, it would be good for younger workers to know. And those who may be in line for drastic cuts in the near term would also welcome some clarification from Mr. Kerry.

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