Executive Summary
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How to Fix Social Security

David C. John

There are only three real solutions to Social Security's rapidly approaching fiscal problems: raise taxes, reduce spending, or make the current payroll taxes work harder by investing them through some form of personal retirement account (PRA).

Establishing PRAs is the only solution that will also give future retirees the opportunity to receive an improved standard of living in retirement. These accounts would give them more control over how to structure their income and allow them to build a nest egg that could be used for emergencies during retirement, used to start a business, or left to their families. However, establishing PRAs will be complex and—as experience from other countries shows—will require careful planning.

To set up a workable PRA system, Congress needs to:

- **Create an account structure that uses a portion of existing payroll taxes and allows workers of all income levels an opportunity to build family nest eggs.** PRAs would be voluntary and would not affect current retirees in any way. Workers would own their Social Security PRAs, which would be funded by directing a portion of their Social Security retirement taxes into their PRAs. About 5 percent of income would be best, but the directed portion should not be less than 2 percent or more than 10 percent. The larger the account, the more likely that it could pay for all or a substantial portion of workers' retirement benefits without requiring more than a token amount of funding through the existing government-paid system.
- **Create a simple, low-cost administrative structure for the accounts that uses the current payroll tax system and professional investment managers.** Probably the simplest and cheapest structure would be the existing payroll tax system. Rather that having the government invest PRA money, the agency overseeing the accounts should contract out fund management to professional fund managers.
- **Create a carefully controlled set of investment options that includes an appropriate default option.** Initially, workers would be allowed to put their PRA contributions into any one of three balanced and diversified mixes of stock index funds, government bonds, and similar pension-grade investments. The default fund for workers who do not make a choice would be a lifestyle fund in which the asset mix changes with the age of the worker. Younger workers would be invested fairly heavily in stock index funds; but as they age,

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their funds would automatically gradually shift toward a portfolio that includes a substantial proportion of bonds and other fixed-interest investments. This would allow workers who are far from retirement to grow with the economy while older workers would lock in that growth with a portfolio made up predominantly of lower-risk investments.

- **Adjust Social Security benefits to a more sustainable level for future generations.** Despite promises from both the left and the right to pay promised benefits in full, this is simply not realistic. While current retirees and those close to retirement should receive every cent that they are due, future benefit promises must be scaled back to more realistic levels.
- **Create a realistic plan for paying the general revenue cost of establishing a PRA system.** The necessary money will have to come from some combination of four sources: borrowing additional money, collecting more general revenue and other taxes, reducing other government spending, and reducing Social Security benefits more than is required under current law or in the reform plans. While some Representatives and Senators will be tempted to cover Social Security's deficits with higher taxes, this is the wrong approach. The necessary amounts are so large that such a tax increase would consume enough resources to harm the economy.
- **Create a system that allows workers flexibility in structuring their retirement benefits while ensuring that they receive an adequate monthly benefit.** To protect both the retiree and the taxpayer, a PRA plan should require all retirees to use some of their PRAs to purchase annuities that would guarantee at least a minimal level of income for life, including an adjustment for inflation. This would protect taxpayers from retirees who would otherwise spend their entire PRAs, expecting some form of government handout to meet their monthly expenses.

Any plan to fix Social Security should:

- **Improve the retirement income of future retirees without reducing the benefits of current retirees or those close to retirement.** Social Security reform should not reduce the benefits of today's retirees or those close to retirement.
- **Add voluntary PRAs that include a savings/nest egg component to the current system.** In the future, Social Security retirement benefits should come from both the current government-paid program, which would become Social Security Part A, and from the individual worker's PRA, which would be known as Social Security Part B.
- **Reduce the unfunded burden that today's Social Security system will impose on future generations.** A sensible reform would reduce the benefits promised to younger workers to more affordable levels while also allowing them the opportunity to make up the difference through investment earnings. Continuing to promise those who are a long way from retirement more than Social Security can realistically deliver only makes the system unstable by pushing the burden of paying for it onto future generations.

Conclusion. It is not fair either to force senior citizens into poverty because of low Social Security benefits or to beggar their children and grandchildren by requiring them to pay for unrealistic promises. Establishing Social Security PRAs is the only way to avoid both of these extremes.

Because PRAs would earn higher returns than the current system can afford to pay, they could preserve retirement benefits at a sustainable level and reduce the unfunded promises imposed on future generations. However, PRAs are not a magic bullet. To work properly, a PRA system must be carefully structured and administered. The system must neither promise more than it can reasonably be expected to deliver in benefits nor attempt to hide its true cost through budget tricks.

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Establishing PRAs is the only solution that will also give future retirees the option to receive an improved standard of living in retirement. These accounts would give them more control over how to structure their income and allow them to build a nest egg that could be used for emergencies during retirement, used to start a business, or left to their families. However, establishing PRAs will be complex and—as experience from other countries shows—will require careful planning.

How can such a reform be achieved? Whatever emerges from Congress and is signed into law will not be identical to any one proposal presented to Congress. It may contain key elements from a number of specific proposals. As this process unfolds, however, it is critical that lawmakers committed to reform maintain a clear picture in their minds of the framework needed for reform and what variants of basic ideas can be accommodated without undermining the basic goals of reform.

What should such a framework look like? What choices within this framework would still achieve the goals of reform? This paper lays out a practical framework for establishing a successful PRA program that will improve the retirement incomes of future

Talking Points

To establish a workable system of Social Security personal retirement accounts (PRAs), Congress needs to create:

- An account structure that uses a portion of existing payroll taxes and allows workers of all income levels an opportunity to build family nest eggs.
- A simple, low-cost PRA administrative structure that uses both the current payroll tax system and professional investment managers and has a carefully controlled set of investment options that includes an appropriate default option.
- A fair method to adjust Social Security benefits to a more sustainable level for future generations.
- A realistic plan for paying Social Security's unfunded liability.
- A system that allows workers flexibility in structuring their retirement benefits while ensuring that they receive an adequate monthly benefit.

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retirees and reduce the huge unfunded liability of the current Social Security system.

A Framework for Reform

A practical framework for establishing a successful PRA program would:

- **Create an account structure that uses a portion of existing payroll taxes and allows workers of all income levels an opportunity to build family nest eggs.** The PRAs would be voluntary and would not affect current retirees or those close to retirement in any way. The Social Security PRAs should be funded by directing a portion of their Social Security retirement taxes into their PRAs. About 5 percent of income would be best, but the directed portion should not be less than 2 percent or more than 10 percent.
- **Create a simple, low-cost administrative structure for the accounts that uses the current payroll tax system and professional investment managers.** Using the existing payroll tax system would reduce costs. Rather than having the government invest PRA money, the agency overseeing the accounts should contract out fund management to professional fund managers.
- **Create a carefully controlled set of investment options that includes an appropriate default option**. Initially, workers would be allowed to put their PRA contributions into any one of three balanced and diversified mixes of stock index funds, government bonds, and similar pension-grade investments.
- **Adjust current Social Security benefits to a more sustainable level.** Despite promises from both the left and the right to pay promised benefits in full, this is simply not realistic. While current retirees and those close to retirement should receive every cent that they are due, future benefit promises must be scaled back to more realistic levels.
- **Create a realistic plan for paying the general revenue cost of establishing a PRA system.** The necessary general revenue will have to come from some combination of borrowing additional money, collecting additional taxes, reducing other government spending, and reducing Social Security benefits. While some Representatives and Senators will be tempted to cover Social Security's deficits with higher taxes, this is the wrong approach. The necessary amounts are so large that such a tax increase would consume enough resources to stall economic growth.
- **Create a system that allows workers flexibility in structuring their retirement benefits while ensuring that they receive an adequate monthly benefit.** A PRA plan should require all retirees to use some of that money to purchase an annuity that would guarantee at least a minimal level of income for life, including an adjustment for inflation. This requirement would protect taxpayers against retirees who could otherwise spent their entire PRAs and then expect some form of government handout to meet their monthly expenses.

The Challenges Facing Today's Social Security

According to the Congressional Budget Office, approximately 80 percent of Americans pay more in payroll taxes than in federal income taxes.[1] Today's Social Security system provides retirees with a stable retirement income and a level of protection against poverty caused by disability or the premature death of a parent or spouse.

Despite the presence of private methods to invest for retirement, in 2001 approximately one-third of retirees on Social Security received at least

1. "Economic theory and empirical evidence suggest that workers bear much of the employer's portion of the payroll tax through lower wages and reduced fringe benefits. If the employer-paid portion of payroll tax receipts is counted as the contribution of the worker, roughly 80 percent of taxpayers pay more in payroll taxes than in income taxes." The 80 percent figure includes payroll taxes for Social Security Disability Insurance and a portion of Medicare in addition to Social Security's retirement and survivors program. Congressional Budget Office, *Economic Stimulus: Evaluating Proposed Changes in Tax Policy*, January 2002, p. 12, footnote 7, at *ftp.cbo.gov/32xx/doc3251/FiscalStimulus.pdf* (January 26, 2004).

90 percent of their income from that program. Almost two-thirds of them depended on Social Security for at least 50 percent of their retirement income.[2] These workers would likely benefit the most from a PRA that allowed them to invest some of their payroll taxes.

Today's Social Security faces four major problems that threaten its ability to provide future retirees the same type of retirement security that was available to their parents and grandparents:

- **Massive future deficits.** In less than 15 years (approximately 2018), Social Security's retirement program will begin to spend more per year in benefits than it receives in taxes. Within a few years, these deficits will exceed $100 billion annually and will continue to grow from there. Social Security has a "trust fund" drawer full of government bonds, which are nothing more than pledges to use ever-larger amounts of general revenue taxes to pay benefits. When it comes time to repay those bonds, the federal government will have to reduce spending on other government programs, increase taxes, and/or increase government borrowing. By about 2042, the drawer of paper promises will be empty. From that point forward, the benefits paid to retirees will be cut—first by 27 percent and then by ever-greater amounts—as Social Security's deficits grow larger.
- **The inability of workers to build a nest egg and the lack of property rights to their benefits.** Today's Social Security not only fails to provide workers with any way to build a family nest egg, but also actually discourages savings by absorbing a large proportion of earnings that moderate-income and low-income workers could otherwise use to save for retirement or other purposes.[3] In addition, workers have no property right to their benefits. This is a key flaw because, even if the program was reformed to allow workers to build a family nest egg, without property rights the government could reclaim that money at any time. Two Supreme Court cases dealing with Social Security confirm this lack of property rights.[4] The decisions in both cases explicitly state that workers have no level of ownership of their Social Security benefits.
- **A poor rate of return on their payroll taxes.** Younger and lower-income workers will receive relatively little in benefits for their Social Security taxes because they will have to pay substantially higher taxes than older workers do. A 25-year-old male with an average income is predicted to receive a –0.82 percent rate of return on his Social Security taxes. In other words, he will pay more into the system in taxes than he will receive back in benefits. The situation is even worse for low-income workers. A 25-year-old male living in a low-income section of New York City would receive a –4.46 percent rate of return on his Social Security taxes.[5]
- **No choice of how benefits are paid.** Under the current inflexible system, all workers receive a monthly payment that starts when they retire and ends when they die or when their spouses or dependents die. This one-size-fits-all approach especially hurts the one-fifth of white males and the one-third of African–American males who die between the ages of 50 and 70.[6] These workers face the prospect of paying a lifetime of Social Security taxes in return for little or no retirement benefits. A more flexible system would give them the comfort of knowing that at least a portion of their taxes will go to their families in the form of a nest egg.

2. Social Security Administration, *Income of the Aged Chartbook, 2001*, May 2003, p. 10, at *www.ssa.gov/policy/docs/chartbooks/income_aged/2001/iac01.pdf* (November 15, 2004).
3. All taxes reduce income and thereby reduce the ability to save or consume. Social Security also reduces the incentive to save because it provides retirement benefits that substitute for private savings. Virtually all of the research in this area identifies this "substitution effect" as the source of Social Security's impact on savings. See Congressional Budget Office, "Social Security and Private Saving: A Review of the Empirical Evidence," *CBO Memorandum*, July 1998, at *www.cbo.gov/ftpdocs/7xx/doc731/ssprisav.pdf* (November 15, 2004).
4. *Helvering v. Davis*, 80 U.S. 1367 (1937), and *Flemming v. Nestor*, 57 U.S. 904 (1960).

Goals for Fixing Social Security

To focus the reform debate on real solutions, it makes sense to develop several overarching goals to ensure that all of Social Security's problems are fixed both for the next few years and for the foreseeable future. An unfocused debate would fix only certain problems while leaving the others to worsen. An incomplete or poorly considered reform would result in the same debate being replayed in a few years in an atmosphere in which there will be even less flexibility to resolve the system's financial crisis.

We therefore owe it to our children and grandchildren to get reform right the first time. When reforming Social Security, policymakers should keep the following goals in mind:

Goal #1: Improve the retirement income of future retirees without reducing the benefits of current retirees or those who are close to retirement.

Social Security reform should not reduce the benefits of current retirees or those who are close to retirement. These workers have spent a lifetime paying their payroll taxes in exchange for the promise that they will receive a set level of benefits. Americans have a moral obligation to pay them every cent that has been promised, including an annual cost-of-living increase to replace the loss of buying power caused by inflation.

At the same time, younger workers should have the opportunity to receive a higher retirement income than the current system will be able to pay by the time they can retire. Workers retiring after about 2042 can really expect to receive only about 73 percent or less of what they are being promised. A reasonable reform would allow them the opportunity to improve their retirement incomes by investing a portion of their current payroll taxes.

Goal #2: Add voluntary PRAs that include a savings/nest egg component to the current system.

In the future, Social Security retirement benefits should come from both the current government-paid program, which would become Social Security Part A, and from the individual worker's PRA, which will be known as Social Security Part B. Workers should be able to choose whether to rely totally on Part A or to invest a portion of their retirement taxes through Part B. As shown by the experience of over 25 countries, including the United Kingdom, Sweden, Switzerland, and Australia, PRAs can help workers to improve their retirement incomes without unreasonable risks.

At the same time, simply establishing PRAs is not sufficient. Social Security Part B should be designed to give workers more control over how their retirement income is structured by allowing them to build nest eggs. Upon retirement, these nest eggs could be used to increase monthly income, reserved for an emergency, or left to family members. In the event that the worker dies before retirement, these nest eggs would remain a part of the worker's estate and could be passed on to heirs.

Goal #3: Reduce the unfunded burden that today's Social Security system will impose on future generations.

Social Security has promised future generations far more in retirement benefits than its current funding sources will be able to pay. Meeting these obligations without reforms will force our children

5. These calculations were made using The Heritage Foundation's Social Security Calculator, at *www.heritage.org/research/features/socialsecurity*. These values are consistent with the calculations of the Government Accountability Office (formerly the General Accounting Office) and others. See U.S. General Accounting Office, *Social Security and Minorities: Earnings, Disability Incidence, and Mortality Are Key Factors That Influence Taxes Paid and Benefits Received*, GAO–03–387, April 2003, at *www.gao.gov/new.items/d03387.pdf* (November 15, 2004), and Lee Cohen, C. Eugene Steuerle, and Adam Carasso, "Social Security Redistribution by Education, Race, and Income: How Much and Why," paper prepared for the Third Annual Conference of the Retirement Research Consortium on "Making Hard Choices About Retirement," Washington, D.C., May 17–18, 2001, at *www.bc.edu/centers/crr/papers/Third/Cohen-Steuerle-Carasso_Paper.pdf* (November 15, 2004).
6. Robert N. Anderson and Peter B. DeTurk, "United States Life Tables, 1999," in National Center for Health Statistics, *National Vital Statistics Reports*, Vol. 50, No. 6 (March 21, 2002), pp. 15–16 and 21–22, at *www.cdc.gov/nchs/data/nvsr/nvsr50/nvsr50_06.pdf* (November 16,2004).

and grandchildren to pay crushing payroll taxes, which will sharply reduce their standard of living. In addition, because payroll taxes are essentially a levy on jobs, substantial payroll tax increases will reduce economic growth and kill jobs.

This also applies to the amount of additional general revenue money that will be required to pay full benefits under a PRA plan. Even though this cost will be substantially lower than the amount that would be required to pay full benefits under the current system, reformers should not repeat the mistake of trying to build political support today by pushing substantial costs onto future generations.

A sensible reform would reduce the benefits promised to younger workers to more reasonable levels while also giving them the time and tools necessary to make up the difference through investment earnings. Continuing to promise those who are a long way from retirement more than Social Security can realistically deliver only makes the system unstable by pushing the burden of paying for it onto future generations.

Six Steps to Creating a Workable PRA System

Step #1: Create an account structure that uses a portion of existing payroll taxes and allows workers of all income levels an opportunity to build family nest eggs.

Who Could Participate? PRAs would be voluntary. Younger workers would have the opportunity either to open a PRA or to continue in the current system and accept whatever benefits it could afford to pay at their retirement. Because the PRA plan would allow the worker the opportunity to receive higher retirement benefits than the government-paid system could afford to pay, workers would automatically have a PRA unless they opt out of the system.[7] Opting out could be accomplished by filing a simple form with the Social Security Administration or even by checking a box on the workers' income tax forms.

Current Retirees Would Not Be Affected. No system of PRAs would affect current retirees in any way. They would receive every cent that they have been promised, including an annual cost-of-living increase. This would also be true for workers nearing retirement. Because they would not have the ability to alter their retirement savings significantly, all workers above a certain age (which would be determined in part by the structure of the specific PRA plan) would also receive their full promised Social Security retirement benefits, including cost-of-living increases. Depending on the plan, this age could be as high as 60 or as low as in the 40s. In most cases, it would reflect the worker's age on the date that the plan goes into effect, even if it is announced well before then.

Workers Would Own Their Accounts. A key feature of this system is that workers would own their accounts. Every cent that goes into the PRA would benefit either the worker or the worker's family. Although the worker would not be able to use this money until retirement, the fact that he or she owns it and is able to see how the money is being used would help to prevent future Congresses from attempting to seize retirement money for some politically motivated purpose. In addition, if the worker dies before retirement, amounts left in the PRA after providing for any survivors' benefits would go into the worker's estate and could be left to the family, a church, or any other worthy cause designated by the worker.

Where Would the Money Come From? The money that would go into Social Security PRAs should come from directing a portion of workers' Social Security retirement taxes. Because money in these PRAs would earn higher returns than the current government-paid Social Security benefit, this structure would help the worker to get more for his or her taxes.

Hypothetically, PRAs could be funded by higher payroll taxes, mandatory additional savings, or even some form of general revenue transfer. It would also be possible to find the money for PRAs through some combination of these methods, either with or without directing some of the existing payroll tax. However, every method except

7. It would be easier to administer the PRA system if workers have only one opportunity to opt out of it.

using some of the existing Social Security retirement taxes essentially boils down to a tax increase and would require taxpayers to pay more for their Social Security benefits. This, in turn, would reduce the already low return that workers get for their retirement taxes to an even lower amount. In addition, higher payroll taxes would negatively affect the economy by reducing employment and curbing economic growth.

How Large Would the Accounts Be? Currently, workers pay a total of 10.6 percent of their income for Social Security retirement and survivors' benefits.[8] To fund PRAs that have a chance of paying for substantial portions of workers' retirement benefits, an amount of payroll taxes equal to about 5 percent of income should be deposited into their PRAs.

In theory, PRAs could be any size, ranging from about 2 percent of earnings to as much as 10 percent. However, in order to have any effect on future liabilities, these accounts should not be any smaller than 2 percent of income.

Because larger accounts—about 5 percent of income or more—create useable pools of money much faster than smaller ones, they are more likely to be able to pay for a higher proportion of the owners' Social Security benefits. This would sharply reduce costs for future generations and make it more likely that the reformed system could pay benefits closer to the level promised by today's system. The higher shorter-run general revenue requirements of establishing a system of larger personal retirement accounts would be more than offset by the reduction in the system's unfunded liability.

However, larger accounts will also require larger amounts of general revenue to make up the difference between the remainder of Social Security's payroll taxes and what the program owes in benefits. While the necessary general revenue transfers would be less than under the current Social Security system, they would still be significant.[9] As a result, if the additional general revenue costs of a system of larger PRAs is beyond Congress's ability to finance for now, it may choose to establish smaller PRAs.

"Progressive" Accounts. Today's program recognizes that low-income workers are much more likely than those with higher incomes to have no retirement benefits other than Social Security. As a result, those workers are currently given a higher monthly benefit relative to their earnings.[10] A PRA system could duplicate or exceed the current program's progressivity by allowing low-income workers to save a higher proportion of their payroll taxes. For instance, a minimum-wage worker might be allowed to save up to 6 percent to 8 percent of income each year, while the highest-income worker could save only about 2 percent to 4 percent. Because the amount of each worker's contributions would be calculated by the Department of the Treasury based on the worker's tax forms, it would be no harder for the Treasury to use this sliding scale than it would be to administer a system under which everyone contributes the same proportion of his or her salary.

There are two other benefits to this approach. First, because younger workers almost always start in fairly low-income jobs, it would allow them to build up account balances more rapidly than a flat

8. Half of this amount (5.3 percent) is deducted from the worker's paycheck, and the employer pays the other half. As far as the employer is concerned, the employer-paid share is really part of the worker's salary because the tax is incurred for employing that particular worker. In addition, other payroll taxes totaling 1.8 percent of wages pay for Social Security's disability program, and a further 2.9 percent pays for Medicare.

9. The amount of general revenues required would depend on the plan's design and the extent to which it offsets future promised benefits.

10. However, a recent study suggests that the progressivity of the current Social Security program is overstated and that lower-income workers actually do worse than is popularly believed. For more details, see Alan L. Gustman and Thomas L. Steinmeier, "How Effective Is Redistribution Under the Social Security Benefit Formula?" *Journal of Public Economics*, Vol. 82, No. 1 (October 2001), pp. 1–28. An electronic version of an earlier draft is available at *www.dartmouth.edu/~agustman/Redistr6.pdf* (November 10, 2004).

contribution level would. These balances would grow throughout the remainder of the workers' careers. Second, a sliding scale that allows lower-income workers to place a higher proportion of their incomes in a PRA should help to lower administrative fees by reducing the number of very small annual contributions that the system would need to handle.

Another feature that could be added to a PRA system would be to give workers the option to make additional contributions up to a certain amount. Ideally, these additional contributions would receive the same tax treatment as contributions to individual retirement accounts (IRAs) and other retirement savings plans currently receive.

Building Nest Eggs for the Future. A well-designed retirement system includes three elements: regular monthly retirement income, survivors' and dependents' insurance, and the ability to save. Today's Social Security system provides a stable level of retirement income and provides benefits for survivors and dependents, but it does not allow workers to accumulate savings to fulfill their own retirement goals or to pass on to their heirs. Workers should be able to use Social Security to build a cash nest egg that can be used to increase their retirement income or to build a better economic future for their families.

A PRA system should be designed to allow every worker at every income level the opportunity to leave a nest egg to his or her family. Today, less than 13 percent of all households making less than $20,000 have ever received inheritances.[11] Only among families making over $100,000 does the frequency of inheritance exceed 25 percent. However, a properly designed PRA system would not limit inheritances to the rich. Everyone would be able to use his or her PRA to build a cash nest egg that could become an inheritance.[12]

Step #2: Create a simple, low-cost administrative structure for the accounts that uses the current payroll tax system and professional investment managers.

A simple and effective administrative structure is essential to the success of a PRA system. Probably the simplest and cheapest structure would be to use the existing payroll tax system. Under today's Social Security, the employer collects and sends to the Treasury Department both the payroll taxes that are withheld from an employee's check and those that are the responsibility of the employer. The payroll tax money from all of the firm's employees is combined with income taxes withheld from their paychecks and sent to the Treasury. The money collected is allocated annually to individual workers' earnings records after worker income tax records have been received.

Adapting this existing administrative structure to a PRA system would be easier to implement than other options. Under a PRA system, the employer would continue to forward to the Treasury Department one regular check containing payroll and income taxes for all of the firm's employees. The Treasury would continue to use its existing formula to estimate the amount of receipts that should be credited to Social Security and to reconcile this amount annually with actual tax receipts.

Once the Treasury determines the amount to be credited to Social Security, it would estimate the portion that would go to PRAs and forward that amount to a holding fund managed by professionals who would invest the amount in money market instruments until it is credited to individual taxpayers' accounts. The money would go to individual workers' accounts upon receipt of their tax information. It would then be invested in the default fund, except for workers who have selected (on their income tax forms) one of the other

11. Calculated by the Center for Data Analysis using data from Federal Reserve Board, "2001 Survey of Consumer Finance," at *www.federalreserve.gov/pubs/oss/oss2/scfindex.html* (February 17, 2003). In this analysis, any major inheritance, gift, or bequest is considered an inheritance. Income figures represent adjusted gross income.

12. William W. Beach, Alfredo B. Goyburu, Ralph A. Rector, Ph.D., David C. John, Kirk A. Johnson, Ph.D., and Thomas Bingel, "Peace of Mind in Retirement: Making Future Generations Better Off by Fixing Social Security," Heritage Foundation *Center for Data Analysis Report* No. CDA04–06, August 11, 2004, at *www.heritage.org/Research/SocialSecurity/CDA04-06.cfm*.

investment options, in which cases it would be invested accordingly.[13]

Using Professional Fund Managers. Rather that having the government trying to invest PRA money, the agency overseeing the accounts (which could be the Department of the Treasury, the Social Security Administration, or an independent board) should contract out fund management to professional fund managers. This investment management system is currently used by the Federal Employees Thrift Investment Board, which administers the Thrift Savings Plan, a part of the retirement system for federal employees.

Under this system, management of the specific investment pools would be contracted out to professional fund managers, who would bid for the right to manage an asset pool of a certain size for a specified period of time. The manager could invest the money only as directed by the agency. The agency would also contract out to investor services such tasks as issuing regular statements of individual accounts, answering account questions, and handling transfers from one investment option to another.

Advantages of this Administrative Structure. Building on existing structures and contracting out investment management and services should keep costs to the lowest level possible. In addition, employers would not have to change their current payroll practices. Using one central government entity to receive PRA funds also means that employers would not bear the cost of writing individual checks or arranging for individual fund transfers for each employee. In addition, this method allows the PRA contributions of workers who have multiple jobs to be based on their total income without placing any additional burden on either the worker or the employers.

From a worker's standpoint, this should be the lowest-cost structure available. In addition, because workers' PRA contributions would be distributed to their chosen investment plans only after their tax information has been received, workers with several jobs during a year should see contributions based on their total annual incomes.

Step #3: Create a carefully controlled set of investment options that includes an appropriate default option.

The investment options available to PRA owners should be simple and easily understood. While an increasing number of Americans are investing their money for a wide variety of purposes, a voluntary PRA system would bring in millions of new investors who may not have any previous investment experience. In addition, experience from both the 401(k) retirement plans and federal employees' Thrift Savings Plan shows that costs are far lower if the plan starts with only a few investment options and then adds more once the plan is fully established.

Carefully Controlled Investment Options. All investment options available under a PRA plan should be limited to a diversified portfolio composed of stock index funds, government bonds, and similar assets. Even if they so desire, workers would not be allowed to invest in speculative areas such as technology stocks or to choose specific stocks or bonds. Money in a PRA is intended to help to finance a worker's retirement security, not to be risked on speculative investments with the hope that taxpayers will support the worker if the investment fails.

Initially, workers would be allowed to put their PRA contributions into any one of three balanced and diversified mixes of stock index funds, government bonds, and similar pension-grade investments. Although the exact mix of assets would be determined by the central administrative agency, one fund might consist of 60 percent stock index funds and 40 percent government bonds, while another might be 60 percent government bonds and 40 percent stock index funds.

The third fund, which would also act as the default fund for workers who failed to make a choice, would be a lifestyle fund. These are funds in which the asset mix changes with the age of the

13. A similar administrative structure was developed during the Clinton Administration by experts from the Department of the Treasury and the Social Security Administration. State Street Corporation also developed this model independently in 1999.

worker. Younger workers would be invested fairly heavily in stock index funds, but as they age, their funds would automatically shift gradually toward a portfolio that includes a substantial proportion of bonds and other fixed-interest investments. This is designed to allow the portfolios of workers who are far from retirement to grow with the economy and to allow older workers to lock in that growth by making their portfolios predominantly lower-risk investments.

Workers would be allowed to change from one investment fund to another either annually (by indicating their choice on the income tax form) or at other specified times (by completing a form on the Internet). They would also receive quarterly statements showing the balance in their accounts. As with today's Social Security, PRA accounts are intended strictly for retirement purposes, and no early withdrawals would be allowed for any reason.

Keeping Fees Low. Under a successful PRA plan, all investments must be approved by the central administrative agency as being appropriate for this level of retirement investment. That agency would also ensure that administrative costs are kept as low as possible by awarding contracts to manage investment pools through competitive bidding and through direct negotiation with professional funds managers.

Research by State Street Global Investors[14] shows that administrative costs are lower if workers put all their money in one diversified pool of assets rather than attempting to diversify their portfolio by dividing it among several types of assets. For example, a worker who puts all of his or her money in one fund consisting of 50 percent stock index funds and 50 percent government bonds would earn the same as a worker who places half of his or her money in a government bond fund and half in a separate stock index fund. However, the first worker would incur significantly lower administrative costs.

Additional Choices for Larger Accounts. Once a worker's PRA account reaches a certain size threshold (determined by the central administrative agency), he or she would have the option to move its management to another investment manager if that manager offered better service or potentially higher returns. However, only investment managers who had meet strict asset and management quality tests would be allowed to receive these accounts, and the managers would be sharply limited in the types of investments they could offer. In the event that the worker is dissatisfied with either the fees or the returns from these individually managed accounts, he or she could switch back to the centrally managed funds at any time.

Step #4: Adjust Social Security Part A benefits to a more sustainable level.

The sad fact is that today's Social Security promises younger workers much more in retirement benefits that it can possibly hope to pay. Although the program should be able to pay full benefits from its own cash flow until about 2018, after that it will rely on increasingly larger amounts of general revenue taxes to pay the promised benefits. Initially, these amounts will be paid to retire the bonds in the Social Security trust fund, with the annual amount of general revenue needed to pay full benefits rising from approximately $20 billion in 2018 to over $600 billion by the time the last bond is redeemed in about 2042.[15] After that, the existing law requires Social Security to reduce its benefits to the amount that it can pay using payroll taxes. After about 2042, that would require a 27 percent cut in benefit payments.

Despite promises from both the left and the right to pay the promised benefits in full, this is simply not realistic—in part because the benefit levels of new retirees are increased each year beyond the rate of inflation. While current retirees and those close to retirement should receive every cent that they are due, future benefit promises must be scaled back to more realistic levels.

At the same time that benefits are becoming more realistic, it is essential that PRAs be established to allow workers the opportunity to

14. State Street Corporation, "Administrative Challenges Confronting Social Security Reform," March 22, 1999.

15. Both figures are in 2004 dollars (i.e., adjusted for inflation).

restore—and even improve—their benefits through a carefully controlled investment program. The combination of realistic government-paid benefits and a PRA would be far more secure than the current system of empty promises.

Ideally, aggregate Social Security Part A benefits should be reduced gradually to a level that could be sustained by the program's income. However, this would have to take place over a substantial time so that workers can adjust their retirement planning. In the interim, Social Security's cash flow would have to be supplemented by general revenues, but a reformed Social Security plan using PRAs would cost substantially less than what the current system will need to pay for its promises.

Changing How Social Security Benefits Are Calculated. One of the reasons that today's system will be unable to pay all of its promised retirement benefits without substantial tax increases is the way benefits are calculated. When retirement benefits are calculated, workers' pre-retirement earnings are increased by both inflation and the growth rate of wages across the entire economy. The total of the two is higher than using an inflation index alone. As a result, benefits for new retirees grow each year, even after adjusting for inflation. In addition, retirees receive an annual cost-of-living adjustment increase to reduce the effect of inflation on their benefits.

One way to bring Social Security's benefits into line with what it can afford to pay would be to change how new retirees' benefits are calculated so that their past earnings are increased only by the rate of inflation.[16] If PRA earnings supplemented these results, workers would receive an improved level of retirement income, which would generally be above what today's Social Security could afford to pay. In addition, this would sharply reduce the program's annual deficits.

Improved Benefits for Lower-Income Workers. Another advantage of a PRA system would be a minimum benefit that would protect all workers from retiring into poverty after working a full career. Because today's Social Security pays benefits based strictly on past income, it is possible for the lowest-paid workers to work a full career and then receive retirement benefits that are significantly below the poverty level.

A PRA system should be designed to pay these lowest-income workers a minimum benefit that is *at least* the poverty level, or perhaps even twice the current poverty level.[17] These minimum benefits would be paid through a combination of government-paid Social Security Part A and PRA-financed Social Security Part B. In the event that the combinations would still be below the designated minimum benefit, the difference would be added to the government-paid amount.

Benefits Calculation Under a PRA System. The way that the two parts of Social Security interact with each other is crucial. Probably the simplest method would be to have Part A pay a monthly amount based on workers' average earnings while they were working, much as the current system does. To this amount would be added the amount that could be paid through the PRA-funded Part B. If that amount does not equal the system's minimum benefit, the government would pay the difference by adding to the amount paid by Part A.

Under a PRA system, workers would have more control over their retirement options and could choose not to take the full monthly benefit that could be paid through the PRA. This would be allowed as long as the worker chooses at least a certain minimum level of income so that he or she does not become dependent upon government welfare payments for daily living.

An alternate and slightly more difficult way to calculate monthly benefits would be to reduce the Part A benefits by a set amount based on either the monthly income that could be generated by the PRA or the level of contributions to the PRA plus

16. Slightly reducing the bend points in the benefit formula each year would be an equally valid method to offset benefit increases due to the growth of average wages.

17. This level of guaranteed benefits would be payable only to low-income workers who work at least a specified number of years.

some level of interest. Using this method assumes a somewhat higher Part A base benefit than under the preceding method. In this case, either the Part A benefit could be offset by a proportion of the amount payable by the PRA, or the PRA contributions could be assumed to grow by a certain annual amount and the Part A benefit reduced by the result. If the worker's account earned more than the assumed growth rate, he or she would have either higher monthly benefits or a larger nest egg.

An Alternative to Means Testing. Establishing a PRA system is far better than means testing as a way to keep the program solvent. While both changes would reduce benefit costs below what today's system has promised to pay future retirees, means testing begins the process of turning Social Security into a welfare program by denying benefits to workers with incomes above a certain level, even though they have paid Social Security taxes throughout their working lives.

Introducing PRAs would allow Social Security to continue to provide benefits for workers of all income levels. While upper-income retirees are much more likely to have alternate sources of income other than Social Security, as the system becomes unable to pay a higher and higher proportion of benefits from payroll taxes, a means-tested system would be forced to deny benefits to workers at lower and lower income levels.

Changing to an Appropriate Benefit Tax System. Contributions to PRAs should be taxed in the same way that contributions to Roth IRAs and similar retirement savings plans are taxed. Workers should pay income taxes on the money that goes into their PRAs, but both the growth of the account through interest and investment earnings and all withdrawals should be tax-free.

This treatment sharply contrasts with today's Social Security, under which workers pay income taxes on contributions to Social Security and then pay income taxes on up to 85 percent of their monthly benefits (if their total retirement income exceeds $34,000 for single workers or $44,000 for married retirees).[18] While the money raised from this additional tax on certain benefits helps to fund both Social Security and Medicare, it is also a form of means testing. To make matters worse, because the income level subject to income tax is not indexed to inflation, an increasing proportion of retirees are subjected to this tax each year.

Improved Benefits for Those Who Most Need Them. Some workers and their families, particularly spouses who stay at home to raise children and widows and widowers, are treated especially badly by the current system's benefit structure. One of the goals of a PRA system should be to improve benefits for these groups.

Spouses who remain at home to raise children should not be penalized. Their benefits could be enhanced through a combination of improved spousal account options and including at least some of the years spent raising children full-time in the benefit formula. Providing generous incentives to families to continue to put money in the spouse's PRA would pay large dividends. Because most families have children at a fairly young age, that money would have the opportunity to grow for some time and could significantly increase the retirement benefits available to the stay-at-home spouse. The increased spousal PRA could, in turn, reduce the amount of benefits that spouse would receive through Part A.

Improving benefits for surviving spouses who have no income other than Social Security should be another priority. Today, widows and widowers often see major reductions in their Social Security benefits after the death of their spouses. Under current law, a surviving spouse's benefits are usually between 50 percent and 67 percent of what the couple received when both were alive. Surviving spouses should receive at least 75 percent of the benefits the family received when both spouses were alive. That seemingly small amount would make a large difference in their standards of living.

Coordinating Retirement and Disability Benefits. Currently, both Social Security's retirement and survivors' program and its disability program

18. Single retirees with total incomes over $25,000 and married workers with total retirement incomes over $32,000 pay income taxes on 50 percent of their Social Security benefits.

use the same benefit formula. That means that any benefit changes in one program automatically affect the other. However, these two programs are vastly different. One is essentially a retirement savings program for older workers, and the other is a straight insurance program that protects younger workers and their families.

Therefore, when a PRA system is established, Congress should create separate benefit formulas for each program, preserving the current benefit formula for the disability program and adjusting the retirement and survivors' formula to allow for PRAs. This would allow disabled workers to continue to receive the same benefits they receive now. Once they reach retirement age, their benefits would be paid through a combination of any funds available in their PRA and an amount paid by the government. Retirement and disability benefit amounts for older workers would be coordinated to reduce any incentive to receive disability benefits instead of retirement benefits.

Step #5: Create a realistic plan for paying the general revenue cost of establishing a PRA system.

Both the current Social Security system and every plan to reform it will require significant amounts of resources in addition to the money collected through payroll taxes. This additional money, most likely from general revenue taxes, is necessary to reduce the difference between what Social Security currently owes and what it will be able to pay. Under the reform plans, the transition cost represents a major reduction in the unfunded liability of today's program. Even though the reform plans are expensive, all of them require significantly less additional money than today's Social Security system.

Paying for either today's Social Security or any of the reform plans will require Congress to balance Social Security's needs against other pressing needs such as paying for Medicare. In general, as additional dollars are needed for either the current system or a reform plan, fewer will be available for other government programs and the private sector. As the annual amount required grows, Congress will find it increasingly difficult to come up with the money. Additionally, the longer that a plan needs large annual amounts of additional money, the less likely that its benefits will be paid on schedule. This is especially true for the current Social Security system, which will need massive amounts of general revenue funds for an extended period in order to pay all of the promised benefits.

The necessary general revenue will have to come from some combination of four sources: borrowing additional money, increasing taxes, reducing other government spending, and reducing Social Security benefits more than is called for under current law or in the reform plans.

Some plans attempt to specify sources for the general revenues needed, but these are handicapped by the fact that no Congress can bind the hands of a succeeding Congress because the succeeding Congress could change the plan at any time by a majority vote.

The most important thing to remember is that both the existing Social Security system and all known reform plans have this problem. This weakness is not limited to personal retirement account plans or any other reform plan. The only questions are when the cash-flow deficits begin and how large they become.

Creating a Spending Reduction Commission. Given the above limitations, the best way to deal with either the cost of today's system or the smaller amount required to establish a PRA system would be to create a bipartisan spending reduction commission modeled after the successful military base closing commissions. The commission would examine federal programs to identify ones that are wasteful and duplicate, do not accomplish their purposes, or simply can no longer be afforded. It would then report its findings to Congress as a legislative proposal to end, combine, or trim specific programs.

Assuming that Congress gives the spending reduction commission the same powers as the base closing commissions, Congress would then have to consider the report as a whole. Individual committees could examine spending reductions that fall within their jurisdictions, but they would have no authority to amend the proposal, and the entire package would go to the House and Senate floors under an expedited procedure that included an up-or-down vote. An alternative would be to allow amendments, but only if each amendment reduces spending enough to pay for the program that it seeks to preserve. Since, at best, the Social Security deficits will persist for several decades, a series of these commissions would be necessary.

Borrowing. Even under the best of circumstances, some of the costs of either the current Social Security system or a PRA system will likely have to be handled through borrowing. If Congress acts responsibly to reduce spending, borrowing may be necessary simply because some deficits either are larger than expected or occur before they were expected.

However, it would be a serious error to attempt to cover all of the costs through borrowing. This is especially true for the deficits that the current system will begin to incur after about 2018. Not only would the necessary amounts be huge (potentially several times that of the existing federal debt held by the public), but the annual interest costs would rapidly grow to consume a major portion of the federal budget. Debt should be used only to supplement a transition plan, which should be funded mainly through spending reductions.

Structuring Accounts to Reduce Transition Costs. One way to reduce the costs of establishing a PRA system would be to have the accounts invest partly in U.S. government bonds. That way, a portion of the money that moves between Social Security and the PRA would move back to the government account, thus reducing cash-flow deficits. This essentially requires the people who will benefit the most from PRAs to bear a significant part of the cost of establishing the system. In addition to reducing the cost of PRAs, this investment structure also reduces the accounts' risk level.

However, in order for this structure to be more than a financial maneuver, the accounts must be structured so that future generations not only repay the bonds in earlier workers' accounts, but also require a smaller proportion of them in their own accounts. For example, workers born around 1990 might have 40 percent of their accounts in government bonds, while those born in the 2010s would have only 38 percent.

Transition Bonds. Another approach to the costs of shifting to a PRA system would be to use transition bonds, such as those used in Chile's reform during the early 1980s. In this case, workers are given bonds that, when mature, represent the retirement benefits they have already earned in the current system. They are free either to deposit the bond in their PRA or to sell it on the open market and deposit that money in the account.

The bond effectively cashes the individual out of the current system and bases his or her benefits on the amount in that worker's PRA. The specific budgetary consequences depend on when the bond matures, its interest rate, and whether it is paid off in one lump sum (when the worker reaches retirement age) or over time.

Raising Taxes Must Be Avoided. While some Congressmen and Senators will be tempted to cover Social Security's deficits with higher taxes, this is the wrong approach. For one thing, the necessary amounts are so large that such a tax increase would consume enough resources to stall economic growth. In addition, workers already receive an extremely low return on their taxes, and such a tax hike would only make matters worse.

Step #6: Create a system that allows workers flexibility in structuring their retirement benefits while ensuring that they receive an adequate monthly benefit.

Although the savings portion of PRAs receives most of the attention, what happens after an individual retires is equally important. A successful PRA plan can give the worker the ability to tailor his or her retirement income to meet specific goals. Today's Social Security requires all workers to take the equivalent of a lifetime annuity regardless of their health, needs, or financial circumstances.

Annuitization. In order to protect both the retiree and the taxpayer, a PRA plan should require all retirees to use some of their PRAs to purchase annuities that would guarantee at least a minimal level of income for life, including an adjustment for inflation. This requirement would protect taxpayers against retirees who would otherwise spend their entire PRAs and depend on some form of government handout to meet their monthly expenses.

Annuities would be available from private companies through the central administrative agency, as is currently done with the federal Thrift Savings Plan. Workers could also buy them directly from companies if the annuities meet certain financial safety standards. Companies seeking to offer them would be required to have insurance or some other safeguard that would allow the annuity to be paid even if the company ran into financial difficulty. While today's annuities have fairly high administrative costs, these are expected to decline sharply once demand for the product becomes more widespread. The central administrative agency would be able to negotiate with providers to ensure that retirees are charged the lowest fees possible.

However, workers need not convert their entire PRAs into annuities. Ideally, a worker would only be required to purchase a minimal-level annuity that, combined with any government-paid benefit, would meet basic living needs.[19] Of course, a worker could also choose to purchase an annuity that pays a much higher benefit. Married workers would have to purchase an annuity that included a spousal benefit, which would continue to pay monthly income to the surviving spouse.

Workers who chose a minimal-level annuity could use a programmed withdrawal system (similar to those available for today's IRA accounts) to supplement their monthly income. As mentioned above, PRAs would be designed to produce both retirement income and a nest egg that could be used for emergencies during retirement, used to provide a higher retirement income, or left as a legacy to the worker's family. In addition, the worker could retire early if his or her PRA was large enough to purchase an annuity that would pay the minimal-level income for the rest of his or her life.

Conclusion

It is not fair either to force senior citizens into poverty because of low Social Security benefits or to beggar their children and grandchildren by requiring them to pay for unrealistic promises. Establishing Social Security PRAs is the one way that avoids both of these extremes.

Because PRAs would earn higher returns than the current 100 percent government-paid system can afford to pay, they could preserve retirement benefits at a sustainable level and also reduce the unfunded promises that future generations will have to pay. However, they are not a magic bullet. In order to work properly, a PRA system must be carefully structured and administered. Whether reformed with PRAs or not, the system must neither promise more than it can reasonably be expected to deliver in benefits nor attempt to hide its true cost through budget tricks.

The experience of over 25 countries shows that PRA systems can be structured to deliver improved benefits in a cost-effective way. Rather than waiting for the inevitable crisis to arrive, Congress should establish a Social Security Part B that includes PRAs. Delay just makes the eventual cost higher while denying younger workers increased control over their own retirements and the ability to create nest eggs for their families.

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19. If this is not politically feasible, an alternative might be to require that the annuity and any government-paid benefit must equal the promised benefits under the PRA system.