the weekly Standard

Saving Private Accounts

The missing ingredient in the Social Security debate.

by Lawrence B. Lindsey

03/28/2005, Volume 010, Issue 26

LAST YEAR AMERICANS SPENT--on consumption, investment, and government--$1.06 for every dollar we earned. We balanced our collective checkbook only by selling assets we owned and by borrowing directly from foreigners, including institutions like the People's Bank of China, to whom one might prefer not to be increasingly indebted. This borrowing is directly tied to an ever growing trend for us to consume foreign-produced goods at the expense of American production. At the moment, foreigners are lending to us quite willingly and at low interest rates, in large part because it helps their own economic strategies. But it would be irresponsible to assume that this lending will go on indefinitely.

So it is surprising that the issue of promoting national saving is not at the center of the debate over Social Security reform. Done right, the reform process offers enormous potential for improving our national saving rate and thus reducing the amount we are borrowing from foreigners over the next century. This is a historic opportunity to adopt a safer economic course. But we must move carefully because there is ample confusion in Washington on the different approaches and their effects on saving.

The first part of any credible Social Security reform plan is to eliminate the actuarial deficit in the system. The system has promised to pay out, in present value terms, $10 trillion more than it will collect in revenue. There are a number of ways of closing this gap, but with different implications for national saving.

One way is to raise payroll taxes by 50 percent to make sure that the government collects all the money it needs to pay the benefits now promised. At best, this might increase saving for a few decades via deficit reduction, but only if Congress, in a break with its past habits, does not spend the extra revenue on non-retirement programs. Once Social Security payments caught up with the enhanced revenue, though, the plan would forever be moving money from one set of people who would otherwise spend it--workers--to another set of people who would spend it instead--retirees. So even in the best case, this would do little to increase national saving. Even worse would be removing the wage cap that determines both Social Security taxes and benefits. Martin Feldstein calculated that eliminating the cap would produce very little net federal revenue. Entrepreneurs faced with a 50 percent tax rate would pay less federal income tax as well as lower payroll taxes. Much of the lost income would have funded business fixed investment, further lowering national saving.

The second way of bringing the system into balance is to change the formula for determining

benefits, in a way that gradually reduces the current growth rate in real benefits. As things now stand, there will be a 45 percent increase in Social Security benefits, even after inflation, over the next half century. The system could be brought into balance by limiting future benefits to the level enjoyed by those retiring from the system today, while fully indexing those benefits to inflation. This could even be coupled with a generous minimum Social Security benefit, thus both making the system more progressive and providing a better safety net. The $10 trillion saving to the Social Security system of doing this could be viewed as a one-time improvement in the federal government's balance sheet of the same amount, but would also be an equivalent reduction in expected benefits for future retirees.

National saving would likely rise as a result. In order to maintain the level of consumption in retirement that the government previously promised, but could not deliver, individuals would have to gradually increase their personal saving during their working lives. This may not be easy for some folks. So a second part of any Social Security reform that promotes national saving in this way should be a personal account plan that helps people save and learn the benefits of saving by watching their own accounts grow.

The president's proposal would allow workers to direct a portion of their payroll taxes into a personal account. Any shortfall in meeting current benefits because of the taxes redirected to these accounts would be made up for by government borrowing. But, for an individual to establish an account, his regular Social Security benefit would be lowered prospectively by the amount of payroll tax that is diverted into a personal account. Although the president has not specified an exact offset, this adjustment would likely incorporate an interest rate that repays the government for its borrowing costs. Thus, the individual would keep all of the proceeds of his or her personal account and have a net benefit gain equal to the amount by which the actual return in private stocks, bonds, or other investments exceeds the government's borrowing cost.

At present the government's borrowing cost runs between 1.5 percent and 2 percent in real terms, so the odds are high that the individual would come out ahead. By itself, this part of the president's plan is neutral with regard to national saving. So, unlike what some critics say, personal accounts do not need to be "paid for." They already are paid for, with interest, in the reform envisioned by the president.

Still, the national saving opportunity of Social Security reform could be further enhanced. The best way is to allow workers to choose a plan where they would contribute more to their retirement in return for gaining ownership and a higher return on their existing payroll taxes. In effect, Social Security taxes could be used to match these contributions. Many companies successfully use this approach for their own 401(k) plans, but the Social Security match could easily be more generous.

Consider, for illustrative purposes, a plan that asked employees to contribute 1.5 percent of their wages to their own personal account, with no change in their current taxes. Social Security could offer a four-for-one match on employee contributions made on the first $10,000 of earnings and a one-for-one match on contributions made on earnings above that amount. The government match would be funded with existing payroll taxes. A worker making $10,000 would thus contribute $150 a year to his account and be matched $600--producing a $750 account. A worker making $50,000 would contribute $750 a year and be matched $1,200, producing a $1,950 personal account. The resulting accounts would build up much more quickly, generate more earnings, and provide far more funds for retirement. Any future benefit adjustment would relate only to the government's match, not to the employee's contribution.

But as in the president's plan, the Social Security system would be made whole for any diversion of existing payroll tax revenue.

Best of all, national saving would be enhanced unambiguously. The funds being contributed by workers, 40 percent of the amount of the account on average, would largely be net contributions to national saving. They would also involve the real attributes of ownership of capital since the worker would unequivocally have some "skin in the game." Politically, this approach also splits the rhetorical difference in Washington between those favoring an "add on" (new contributions) and those favoring a "carve out" (no new contributions). A high initial match rate would also create the right kind of incentives to change long term attitudes toward national saving, as well as being more progressive than the current Social Security system.

Given the critical importance of saving to our nation's economic future, it is important to make the most of the once-in-a-generation opportunity to promote national saving offered by Social Security reform.

Lawrence B. Lindsey is president and CEO of the Lindsey Group.

© Copyright 2005, News Corporation, Weekly Standard, All Rights Reserved.