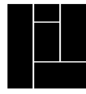
S T R A I G H T T A L K
on Social Security and Retirement Policy



URBAN INSTITUTE

No. 31 • March 15, 2001

GROUNDS FOR COMPROMISE REVISITED: INDIVIDUAL ACCOUNTS

Eugene Steuerle and Adam Carasso

MUCH OF THE PUBLIC DEBATE OVER SOCIAL Security reform has focused on a single issue: investing in privately owned but regulated accounts that hold stock and other assets. Indeed, last year both presidential candidates endorsed reform proposals that included some version of individual accounts. At least in these initial proposals, President Bush envisioned individual accounts as a substitute for part of Social Security, while Vice President Gore saw them as an add-on financed out of general revenues.

Since then, policymakers have offered a host of proposals on how such individual accounts might work. In this issue of Straight Talk, we propose five compromises that draw on different aspects of these recommendations. Our intent is not to capture all the particulars of recent proposals, but to ask: Is there some middle ground?

Before attempting an answer, some background is useful. Currently, the Social Security tax (excluding Medicare) equals 12.4 percent of payroll, with workers and employers each contributing half of that amount. In the arena of Social Security reform, the term "individual accounts" means that contributions are paid into a retirement account owned by the individual. These contributions can be designed either as an "add-on" or "carve-out" provision.

Social Security reformers who advocate a simple 2 percent add-on would raise contributions to Social Security from 12.4 percent to 14.4 percent. Other add-on provisions, such as that proposed by Vice President Gore, would draw on general revenues for their funding rather than additional Social Security taxes or savings mandates.

Those who support a 2 percent carve-out would divert 2 percentage points of the tax to individual accounts, leaving 10.4 percent for the core Social Security system. A carve-out plan might also use general revenues to finance transition to a new system.

But either way, a small amount of private investment cannot restore long-term solvency to the core Social Security system. The first baby boomers will begin retiring around 2009, long before substantial assets can accumulate in these proposed accounts. To create a sustainable Social Security system, policymakers must consider additional reforms, such as scaling back the growth rate of core benefits, raising the retirement age, increasing Social Security taxes, or drawing on general revenues to subsidize Social Security (which would eventually force expenditure cuts or tax increases elsewhere). With this cautionary note in mind, we describe five possible compromises that incorporate recommendations from the different sides of the individual account debate.

Compromise One: Mandate an additional 2 percentage point add-on to the Social Security tax and scale back the benefit growth rate. This compromise increases the percentage of workers' earnings dedicated to mandated retirement systems by 2 percentage points and puts the additional money into individual accounts. At the same time, it scales back the benefit growth rate promised by the current Social Security system (the law promises higher and higher levels of benefits to each succeeding cohort of retirees). Together, the add-on and the scale-back could eliminate the need for a long-term tax increase. Moneys accruing in workers' individual accounts would help offset the reduction in core benefits at retirement.

Compromise Two: Introduce an add-on to the Social Security tax using general revenues, provide subsidies for lower-income individuals, and scale back the benefit growth rate. This approach initially funds individual accounts using general government revenues and spares workers as well as employers a

Social Security tax increase or savings mandate. For a few years, the non–Social Security budget surplus might serve as the source of funds. Because this option depends on general revenues, it would likely require fewer tax cuts or spending increases in the "non-elderly" portion of the budget. Lowering the benefit growth rate could eliminate the need for significant long-term increases in the Social Security tax.

Compromise Three: Introduce a 2 percent carve-out, a subsidy for low-income workers, and benefit reform. This compromise puts a portion of payroll taxes directly into individual accounts. Even with further Social Security reform, transition to an individual account system would require an infusion of general government revenue. Social Security (and government in general) is funded on a pay-as-you-go basis; in other words, this year's tax revenues pay this year's benefit expenditures. Under a carve-out plan, moneys previously devoted to federal coffers would go into privately invested individual accounts. This redirection would temporarily squeeze the government's annual cash flow. Benefit reductions in a core system would also need to be more substantial because of lower revenues. A provision that increases benefits for low-income workers could guarantee higher levels of core benefits for those workers even before the individual account returns are factored in.

Compromise Four: Design an add-on/carve-out provision and introduce benefit reform. This mix-and-match option increases Social Security funds either through a tax or savings mandate but by a smaller percentage than the amount of earnings designated to individual accounts. For example, legislators could increase the Social Security tax from 12.4 percent of payroll to 13.4 percent and designate 2 percent of the overall tax to individual accounts. Alternatively, the total Social Security tax might amount to 14.4 percent, with 4 percent of that rate devoted to individual accounts. Moneys earned in the individual accounts would offset some of the loss of core benefits likely to result from benefit reform.

Compromise Five: Create a government-matching plan in lieu of a mandated system, enact benefit reform, and introduce low-income protection. Under this compromise, a worker or employer (or both) voluntarily contributes a minimum amount to the worker's individual account (say, 6 percent of the worker's wages up to some maximum wage base). In return, the worker enjoys a 2 percent subsidy from the government for the account (for a total of 8 percent of earnings). This reform would leverage up the very modest amount of revenues—typically, 2 percent or less of payroll—that most reformers suggest go to individual accounts. Still, further benefit reform would be required to bring Social Security back into fiscal alignment. A minimum benefit would also be necessary to protect lower-income and nonparticipating workers.

In all of these compromise scenarios, each side must give something up. Such concessions will not be easy. For example, one side believes that any carve-out erodes long-term support for Social Security, while the other side believes that add-ons don't achieve fundamental Social Security privatization (see Straight Talk nos. 11 and 15). Our examples do not address these political constraints, but they do suggest that any compromise will likely need to

- provide additional revenues—either from general revenues or a new savings mandate—to help fund individual accounts, at least for a while;
- narrow the gap between what is possible with existing taxes and what is promised according to the current Social Security benefit formula; and
- include additional protection for low-income retirees, many of whom have uneven work histories, disrupted family lives, and poor investments.

* * *

Eugene Steuerle is a senior fellow at the Urban Institute, where his research includes work on Social Security reform. **Adam Carasso** is a research associate at the Urban Institute.

This series is made possible by an Andrew W. Mellon Foundation grant.

For more information, call Public Affairs: 202-261-5709. For additional copies of this publication, call 202-261-5687 or visit the Retirement Project's Web site: http://www.urban.org/retirement.

Copyright © 2001. The views expressed are those of the authors and do not necessarily reflect those of the Urban Institute, its sponsors, or its trustees. Permission is granted for reproduction of this document, with attribution to the Urban Institute.