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# Policy Brief

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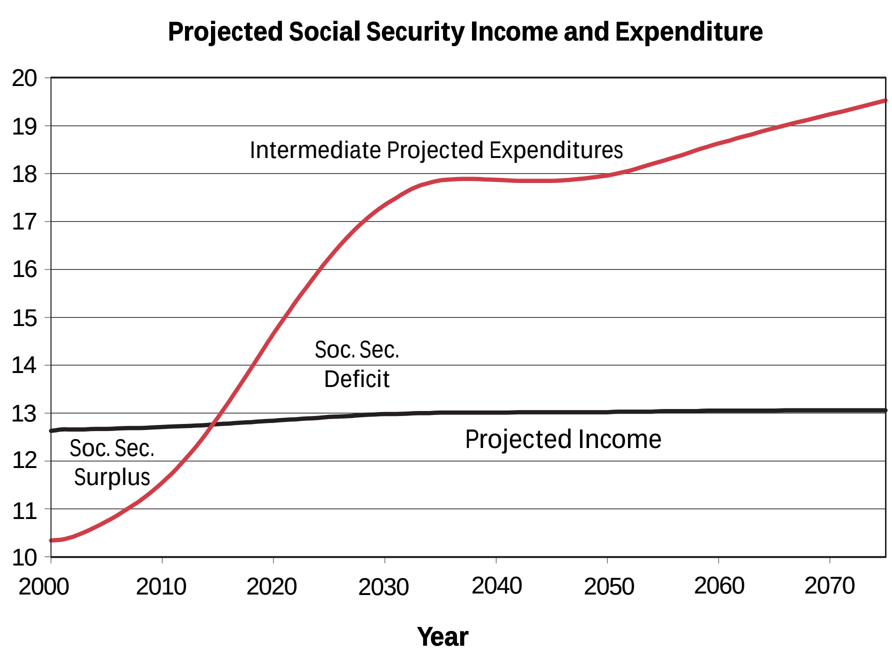
# What President Bush Should Do About Social Security

John B. Shoven

Now that the 2000 presidential election is finally over, what should President George W. Bush really do about Social Security? The basic problem is that the present value of Social Security benefits promised to today's workers and their children significantly exceeds the present value of the forecasted Social Security revenues over the long run: The system is short on money. Figure 1 shows that this is true if you examine only the disability and retirement portions of the program; the situation is much worse if you include Medicare.

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Since Social Security is short on money over the long run, there are really only two solutions –reduce benefits or increase revenues. However, both presidential candidates offered new prescription drug benefits for Medicare and promised not to raise payroll taxes or the normal retirement age.

President Bush proposes allowing workers to divert some fraction of their payroll taxes into new Personal Retirement Accounts that could be invested in private stocks and bonds. His hope is that the higher rate of return offered by common stocks would increase the total retirement resources. While the details have yet to be announced, it is usually assumed that workers would be allowed to direct 2 percentage points of their payroll tax (out of the total of 12.4 percentage points devoted for old-age and disability insurance) into these new accounts.

I am a big supporter of two-tier programs where some of Social Security's benefits are paid out by formula (as in the current program) and some are paid out from the proceeds of individual accounts. So, President Bush gets a good grade for advocating this fundamental structure. However, there are a number of problems with the outline of his plan. Most important, it doesn't increase total revenues and it doesn't specify any benefit cuts. Therefore, it doesn't tackle the basic long-run shortfall. Almost as serious a problem is that participation in the new accounts is voluntary. Social Security has always been designed to help those who are myopic and therefore wouldn't save enough for their own retirement. People who open these new Personal Retirement Accounts display a certain amount of foresight and probably already have 401(k) accounts and/or Individual Retirement Accounts. What about the people who fail to take advantage of the new accounts and therefore don't have the corresponding assets for retirement? They are the ones who most need help from the government. Social Security has always been mandatory for good reason. It probably should stay that way.

## A Matching Contribution Proposal

The toughest task for President Bush is to raise the system's revenues without raising taxes. This may seem like a Gordian knot, but I think there is a way to do it. What if in order to get access to the 2 percentage points of your payroll tax, people were required to first contribute 2 percentage points of their covered wages? Now we are talking about 4 percent accounts: 2 representing new money and 2 a diversion of the payroll tax. This single new requirement makes all the difference in the world. The new contributions—2 percentage points of covered payroll—result in enough money to actually tackle the long-run insolvency of the system.

Because of the 1:1 match from existing payroll taxes, participants would accumulate 4 percent accounts. These would eventually involve substantial sums of money and provide a significant contribution towards the retirement of today's young people. With these robust individual accounts, the defined promises of regular Social Security eventually could be scaled back, perhaps through raising the normal retirement age. Even with these cutbacks, the total retirement benefits from Social Security and the individual accounts would exceed the current promised benefits of the system.

Unlike the plans offered during the election, this is not a free lunch plan. Today's young workers would have to contribute an extra 2 percentage points of their covered earnings to their own Social Security sponsored individual account. In return, they would have a system that they could count on to provide a solid base for their retirement needs.

## Matching and Mandatory Solves the Problem with Increasing Taxes

Should the new mandatory 2 percent contribution be considered a tax increase? Some of you will disagree on this, but I say 'no.' This new mandatory contribution goes into the worker's own account. The participant can make the investment allocation decisions, choose amongst withdrawal options, and will the account's assets to heirs. In short, the mandatory contributions create regulated private property. In contrast, taxes don't create private property. A fundamental characteristic of taxes is that the control of the money is transferred from the individual to the government. These mandatory contributions leave substantial control with the contributor subject to a set of governmental rules and regulations. President Bush could propose this new 2 percent mandatory contribution with a 1:1 match and still live up to his promise of no new payroll taxes.

The two changes that I propose to the Bush plan are that the new Personal Retirement Accounts be (1) mandatory and (2) that they feature new contributions from workers and employees that are matched on a 1:1 basis by the government. I call these the M&M changes, matching and mandatory. With these modifications, President Bush could deliver on all of his Social Security promises in the campaign. The Social Security benefits of everyone currently retired or near retirement would remain completely intact. The normal retirement age need not be raised further than in the current law until at least 2027. And, most important, today's young people would have a system that they can count on to be there for them. Probable increased saving resulting from the new personal accounts is a major bonus for the economy as well.

Of course there are many details to be hammered out. What menu of assets would people be allowed to invest in? Would they be allowed to withdraw the money under any circumstances before retirement? How would the administrative costs of the individual accounts be contained? What efforts in financial literacy for the population would be required? Would the government assist the poor with the new mandatory contributions? And, what default portfolio would be chosen for those who fail to make their choices known? Undoubtedly, there are even more issues. Many other countries (such as Chile, Mexico, the UK, Australia, and Sweden) have dealt with these problems and come up with workable solutions. With our advanced financial markets and with the lessons that we can learn from the experiences of others, we should be able to come up with satisfactory solutions to all of these issues.

A new, modernized, and financially sound Social Security system could be achieved in the next four years. While this plan would not have all of the features of my ideal Social Security reform proposal (described in The Real Deal, Yale University Press, 1999), it has the advantage of being based on President Bush's outline. Fixing and modernizing Social Security would be an enormous accomplishment for any presidential administration. Let's hope President Bush and Congress can work together over the next few years to make it happen.



## About the author

John B. Shoven is the Charles R. Schwab Professor of Economics at Stanford University and the Wallace R. Hawley Director, of the Stanford Institute for Economic Policy Research (SIEPR). In addition, he is the former Dean of Humanities and Sciences at Stanford.

Shoven is one of the nation's leading experts on public finance and Social Security. He has been asked to testify many times before Congress and has written and co-authored numerous publications on social security, taxation and investments.

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