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Private Accounts Can Save Social Security

By Martin Feldstein

Although many American retirees now enjoy a comfortable lifestyle financed by a combination of Social Security, private pensions and personal savings, many other retirees are far from financially secure. Someone who retires now after earning average wages all his life will receive Social Security benefits of less than $20,000 annually—not enough to maintain the middle-class standard of living that he had during his working years.

Without meaningful reform in Washington, things will only get worse. There are now three employees paying Social Security taxes to finance the benefit of each retiree. That number will fall over the next three decades to only two employees per retiree. This would require either a 50% rise in the Social Security tax rate to maintain the existing benefit rules, or a one-third cut in projected benefits to maintain the existing tax rate.

That's why every serious budget analysis calls for reducing the growth of Social Security benefits. The bipartisan Simpson-Bowles Fiscal Commission appointed by President Barack Obama proposed slowing the rise in Social Security benefits by increasing the age at which full benefits would be payable, and by changing the benefit formula so that the ratio of benefits to previous wages gradually declines for most future retirees.

Even Mr. Obama accepts the inevitability of lower future Social Security benefits. In his budget speech last month, he reiterated his State of the Union language indicating a willingness to negotiate lower future benefits. After noting that Social Security "faces real long–term challenges in a country that is growing older," he said that future changes must be made "without putting at risk current retirees, the most vulnerable, or people with disabilities; without slashing benefits for future generations; without subjecting Americans' guaranteed retirement income to the whims of the stock market."

Those words, if read carefully, imply that Mr. Obama accepts reducing future Social Security benefits as long as current retirees and the "most" vulnerable are exempted and benefits are reduced gradually (not "slashed"). And while the Social Security taxes are not to be invested in the stock market, some form of universal add-on investment based account is clearly not precluded. This is not fundamentally different from plans developed by Presidents Bill Clinton and George W. Bush: exempt current retirees, reduce future benefits gradually, and supplement tax-financed Social Security with investment-based accounts.

In short, while slowing the growth of Social Security is a necessary response to the changing age structure, it is possible to do it in a way that protects overall retirement incomes by creating universal supplemental personal retirement accounts that generate an annuity for retirees.

Such universal accounts can also help future retirees deal with the cutbacks in Medicare that will inevitably occur because the aging of the population and the increasing cost of health care per retiree will make the current system far too expensive to finance.

The leading Medicare reform plan is a bipartisan initiative proposed initially by House Budget Committee Chairman Paul Ryan (R., Wis.) and Alice Rivlin, a leading Democrat and former head of the Congressional Budget Office. The Rivlin-Ryan plan would change Medicare to a system in which future seniors would receive a voucher with which to buy private health insurance. The value of the voucher would rise over time more slowly than the currently projected Medicare cost per enrollee, implying that many seniors would want to pay extra to buy more comprehensive insurance than the vouchers would finance.

Mr. Ryan included this plan in his House Budget Resolution last month. A recent New York Times survey found that more Americans approve of it than disapprove. Mr. Obama opposes this approach. He proposes instead that future Medicare costs should be reduced by administrative controls, effectively limiting what Medicare will pay for in the future. Either way, future retirees will want more income to pay for additional health-care spending.

The challenge is how to assure that future retirees have accumulated adequate investment-based accounts to supplement Social Security and Medicare. Experience in a wide range of companies shows that a voluntary system can work if employees are automatically enrolled to have payroll deductions deposited into such accounts. Even though employees have the option to stop depositing, they do not do so. Inertia is a powerful force.

Applying this to the entire population requires a method of dealing with individuals who work in small firms, who change jobs frequently, who have multiple jobs, or who are self-employed. An employer-based plan is therefore less practical than one based on the individual.

Here's how such a system might work. Each individual would designate a broad-based mutual fund from a large list of funds approved by the government. The designation could be done on the individual's annual tax return and could be changed once a year. Employers and the self-employed would send an additional few percent of wages to the Social Security Administration each month in addition to the current payroll tax. The Social Security Administration would then forward those dollars to the mutual fund chosen by the individual. The returns on those funds would be untaxed just as they are in an IRA or 401(k).

With a 3% payroll deduction, someone with $50,000 of real annual earnings during his working years could accumulate enough to fund an annual payout of about $22,000 after age 67, essentially doubling the current Social Security benefit. That assumes a real rate of return of 5.5%, less than the historic average return on a balanced portfolio of stock and bond mutual funds. Someone who was extremely risk averse could instead choose to put all of his personal retirement account into Treasury Inflation Protected Securities, accumulating enough with a 5% savings rate for an annual payout of about $13,000. Different combinations of savings rates and investment strategies would produce different expected benefits in retirement.

The automatic extra payroll deduction could start with a less disruptive 1% or 2% and grow as high as 5%. Since every individual would have the option of requesting a refund of that payroll deduction on the following year's income-tax form, the extra saving is strictly voluntary. It is not a tax. And the good news is that experience shows that individuals who are automatically enrolled in such savings plans do not withdraw their funds but leave them to grow.

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