Center for American Progress

A Progressive Framework for Social Security Reform

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A Progressive Framework for Social Security Reform
Executive Summary

Is there room in Washington for a true bipartisan agreement on Social Security reform that increases national savings, individual ownership, and ultimately retirement security? It's a tall order, but doable if both progressives and the president are willing to consider the following four-part framework for bipartisan Social Security reform:

- **A Universal 401(k) to Promote Ownership, Savings and Bipartisanship:** Progressives and conservatives alike should support serious efforts to increase savings, ownership and wealth creation for typical hardworking families. Yet these goals are achievable without dividing Washington by carving up Social Security into private accounts. The president and progressives could both protect Social Security's guaranteed benefit and promote ownership with a new *Universal 401(k)* that offers all Americans a private retirement account on top of Social Security, and uses government funds to match contributions made by middle income and lower-income workers. The Universal 401(k) would spread individual savings and wealth creation to tens of millions of American families currently falling through the cracks by offering all Americans the generous incentives and automatic savings opportunities that the best employer-provided 401(k)'s offer their employees. The components of a Universal 401(k) include:

  - ***Generous $2-to-$1 government matching contributions for initial savings of low-income families and $1-to-$1 matches for middle-income families.*** By targeting new incentives to those families having the hardest time saving, the Universal 401(k) would leverage new private savings.

  - ***A new Flat Tax Incentive of 30 percent for savings done by all workers.*** In addition to matching contributions, the Universal 401(k) would institute a new flat refundable tax credit for retirement savings. The credit would replace our current upside-down system of incentives for retirement savings through tax deductibility, which offers those in the highest tax brackets the most generous incentives to save and lower- and moderate-income families little or no incentive to save.

  - ***A single, portable account that benefits families by continuing to provide strong savings incentives for parents who take time off to raise children or who are between jobs.***

  - ***Stepped-up efforts to strengthen employer-provided 401(k)s by encouraging more employers to automatically enroll their employees.*** Employers would also be encouraged to make it easier for employees to automatically link 401(k) contributions to their salaries to ensure savings does not stagnate. In addition, the Universal 401(k) could include reforms to make it easier for families to directly deposit a portion of their tax refunds straight from their tax form into retirement savings.

  - ***A 5000-to-1 Tax Cut:*** If financed in a fiscally responsible manner by increasing the estate tax exemption to $5-7 million per couple but avoiding outright repeal, the Universal 401(k) would mean that ***for every wealthy estate that would see higher taxes, 5,000 Americans would get a tax cut that could help them someday build an estate of their own***.

- **Mutual Sacrifice and Responsible Financing:** How can the president convince anyone that there is simply no way to fix Social Security other than accepting painful benefit and tax changes, when he just passed tax cuts for the top 1 percent of earners that if made permanent would alone be enough to cover the 75-year Social Security shortfall projected by the Congressional Budget Office? Progressives should insist that any Social Security financing plan be based on the principle of mutual sacrifice – and should ask those most fortunate to bear part of the burden. The best option for mutual sacrifice would be:

- ***A 3 percent surcharge on all income over $200,000 – whether from income, dividends or capital gains – dedicated to increasing national savings now and increasing Social Security solvency***.
- ***The new surcharge would affect only the top 2 percent of taxpayers and, by taxing all income equally, would avoid introducing new distortions and incentives try to turn wage income into dividends or capital gains to avoid payroll taxes.***
- ***The surcharge could be contingent on a bipartisan agreement to find equivalent savings to shore up Social Security through measured revenue and benefit changes.***

- **<u>Real Progress on National Savings and Generational Responsibility</u>:** The one thing nearly everyone in Social Security circles used to agree on was that as we moved closer to the baby boom retirement it was increasingly important to display generational responsibility – to increase national savings now to ensure that we were putting our economy in a better place to deal with known challenges down the road. Indeed, the improvement in the federal fiscal picture in the 1990s – which was substantially driven by a commitment to fiscal discipline and saving surpluses for Social Security – was solely responsible for a doubling of national savings from 3.1 percent of GDP in 1992 to 5.9 percent of GDP in 2000. On the verge of the baby boom retirement, the Bush administration has abandoned the principle of generational responsibility and passed successive rounds of long-term tax cuts that have taken us giant steps backwards – contributing to an erosion of national savings to only 1.4 percent of GDP over the last seven quarters, the lowest level since 1934. ***Even in the wake of this deterioration, there is too little focus in policy discussions about Social Security on increasing savings now. Distressingly, the new gold standard for Social Security plans seems to be that they at best do no harm to national savings***. With our national savings at historic lows and the baby boom retirement at our doorstep, it is absolutely essential that any Social Security reform plan move us back in the right direction by ensuring that we increase national savings now.

- **<u>Commitment to a Bipartisan Process:</u>** While Universal 401(k) accounts outside Social Security alongside mutual sacrifice and recommitment to increase national savings now could provide the substance for a deal on Social Security, the only times when Washington has actually been successful in taking on tough entitlement challenges in recent years without painful political backlash has been when there was a sustained commitment to bipartisanship. Both progressives and President Bush need to heed the lesson that brought Tip O'Neil and Ronald Reagan together on Social Security reform in 1983 and Bill Clinton and Newt Gingrich together on entitlement savings in the 1997 Balanced Budget Agreement. ***If these past leaders have been able to work together on a bipartisan process, the Bush administration and Democratic congressional leadership should be able to as well, but it will require President Bush to display a level of commitment to working through a bipartisan process that has to-date been absent from his fiscal policy approach.***

A Progressive Framework for Social Security Reform

INTRODUCTION:

The right question about President Bush's Social Security reform plan should not just be whether it can attract enough progressive support to give nervous Republicans political cover, but whether there's room for a true bipartisan solution that actually achieves the goals of increasing national savings, spreading wealth creation, and ultimately retirement security. That's a tall order, but doable if both progressives and the president are willing to consider the following four-part framework for bipartisan Social Security reform:

1. A UNIVERSAL 401(K) TO PROMOTE OWNERSHIP, INCREASE SAVINGS, AND INCREASE BIPARTISANSHIP:

Progressives and conservatives should both strongly support efforts designed to truly increase savings and wealth creation for typical hardworking families. Unfortunately, meaningful bipartisan efforts to achieve these goals have been stalled by a stubborn insistence that the main vehicle for such efforts must be through partial privatization of Social Security. Five years ago, for example, President Clinton put forward a USA Account proposal that represented one of the boldest and most expansive proposals ever to spark individual ownership, wealth creation and savings.[2] Accounts like these outside of Social Security represent an enormous opportunity for progressives and conservatives to find common ground on an overall retirement security agreement that both protects the existing guaranteed benefit of Social Security and offers new opportunities to increase individual savings and ownership. President Bush needs to realize that he can achieve the goals of increasing savings and promoting individual ownership without dividing Washington by carving up Social Security into private accounts.

The president and progressives could both promote individual ownership and protect Social Security's guaranteed benefit structure with a new *Universal 401(k)* that offers all Americans a private retirement account on top of Social Security, and uses government funds to match contributions made by middle income and lower-income workers. A new Universal 401(k) accounts would not only be more likely to lead to an overall bipartisan agreement, but is a far more effective way to increase national savings, spread opportunities for ownership and wealth creation, and ultimately strengthen retirement security in the US.

The Universal 401(k): The Universal 401(k) would spread individual savings and wealth creation to tens of millions of American families currently falling through the cracks by offering all Americans the generous matching funds and easy, automatic opportunities for contributions that the best employer-provided 401(k)'s offer their employees. By providing the most generous matching

[2] The USA Account proposal offered a new tax-deferred retirement savings account with progressive government matches and starter funds for low- and moderate income savers. For workers earning under $40,000 USA Accounts offered $300 in starter funds as well as a 1-to-1 match on up to $700 in additional savings into the accounts. For workers earning between $40,000 and $80,000 USA Accounts offered 50 percent matches on their first $1000 of savings, with the credit phasing down and ending for workers making $100,000. For more details on the USA Accounts Proposal see: "White House Press Briefing by NEC Director Gene Sperling and Deputy Treasury Secretary Lawrence Summers," 04/19/99.

refundable tax credits to those with the least ability to save, the Universal 401(k) also helps to turn right-side up our currently upside-down system for tax incentives to encourage retirement savings.

Far too few American workers today benefit from an employer-sponsored 401(k)s where contributions are easy and automatic to make, and incentives to save are often strengthened by generous matching contribution from employers. In 2003, 85 percent of workers in the lowest wage quintile and 73 percent of small-business employees had no employer-sponsored pension. The same was true for 75 percent of Hispanic and 60 percent of African-American workers. Overall, less than half of American workers have an employer-sponsored pension in any given year.[3] The results for retirement security are not pretty: Among households of those 55 to 59 years old, the median amount held in IRAs and 401(k)s is only $10,400.[4]

Unfortunately, our tax system contributes to this Swiss cheese pension coverage by providing an upside down tax incentive that offers the most support to those with the easiest time savings, and the least assistance to those who struggle the most from paycheck to paycheck. As our nation's only mechanism to encourage savings is tax deductibility, taxpayers in the highest income bracket (now 35 percent) are not only more likely to get a matching contribution for their savings from a 401(k) at work, but also get to deduct 35 cents from their taxes for each dollar saved in their 401(k)s or IRAs. Meanwhile, most working families in the 15 percent bracket do not get matching contributions from an employer sponsored pension and when they do save get only a 15 cent deduction for each dollar. And for the 33 million working Americans who pay payroll taxes but do not make enough money to have income tax liability, they are extremely unlikely to have any employer-provided support, have the hardest time affording to save, and yet receive zero incentive to save.[5]

As a result, <u>*of the $146 billion that the federal government forgoes each year to encourage retirement savings through tax deductibility, a pathetic 3 percent goes to the bottom 40 percent of earners*</u> while the top 10 percent of earners receive 49 percent of these tax subsidies.[6]

The goal of the Universal 401(k) would be to fill these holes in our Swiss cheese system by turning these incentives right-side-up. A Universal 401(k) would offer all Americans the opportunity to contribute to a new tax-deferred retirement account, which would be governed by the same contribution and tax deductibility limits as traditional IRAs.[7] The government would then provide moderate- and lower-income workers matching contributions on initial retirement savings deducted

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[3] Annual pension coverage from the Joint BLS/Census Current Population Survey, analyzed by the Economic Policy Institute. Includes private wage and salary workers who worked at least 26 weeks and at least 20 hours a week.
[4] Peter Diamond and Peter Orszag. <u>Saving Social Security: A Balanced Approach</u>. *Brookings Institution Press,* 2004. Table 8-2.
[5] Orszag, Peter and Matt Hall. "Non-Filers and Filers with Modest Tax Liability," *Tax Facts,* August 4, 2003. In addition to the 33 million tax filers with no income tax liability, 8 million filers have less than $500 in income tax liability each year.
[6] OMB FY04 Analytical Perspectives; Leonard E. Burman, William G. Gale, Matthew Hall and Peter R. Orszag. "Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts" Brookings Institution Discussion Paper No. 16, August 2004.
[7] Contributions to traditional IRAs are only tax deductible for workers who are either not participating in an employer-sponsored plan or have incomes of under $40,000 a year (workers with an employer-sponsored pension making between $40,000-$50,000 can deduct part of their contributions). The 2005 contribution limit for traditional IRAs is $4,000 and scheduled under law to increase to $5,000 by 2008.

from their paychecks each year, in the form of refundable tax credits deposited directly into their Universal 401(k)s.

For low-income families that are having the hardest time saving, the government could offer a strong, generous incentive for them to put money away, with a 2-to-1 match on the first $2,000 of savings accumulated in the accounts. In other words, if a low-income family was able to save $667 a year, the government would contribute an additional $1333 into their Universal 401(k) to give the family $2,000 of savings in their account. If the family was able to save more, they would be able to contribute as much as $2,000 in additional savings on their own – as current law allows up to $4,000 in annual contributions to IRAs. While many low-income families struggling to make ends meet have trouble saving large amounts, the power of the 2-to-1 match and the prospect of accumulating $2,000 in annual savings would hopefully compel millions of families to get into the habit of saving at least $667 a year. If such incentives proved to still not leverage savings from working poor families, we could consider potentially including so-called "starter funds" – automatic tax credits deposited into a Universal 401(k) independent of individual contributions – for a limited number of years for each recipient.

For middle-income families, the government could offer a somewhat less generous but still powerful 1-to-1 match on savings, so that a family that contributed $1,000 into their Universal 401(k) would get an additional $1,000 in matching funds form the government and end up with $2,000 in their accounts. Depending on affordability, a 30 percent-50 percent match could be offered for the initial contribution to somewhat higher-income middle class taxpayers as well.

A Second Component of the Universal 401(k): Flat Tax Incentives for Retirement Savings: Another way to encourage savings beyond matching the initial savings done by working poor and moderate-income workers would be to replace our entire upside-down system of tax deductions for retirement savings with *a flat tax incentive of 30 percent for savings done by all workers*.[8] Replacing the deduction-based system with flat tax credit of 30 percent for all savings done by all workers regardless of income would represent real progressive tax reform.[9] It would ensure that those eligible for matching contribution still had a strong incentives to save beyond the initial $2,000 accumulated in their accounts. Those in the 15 percent bracket would see their tax incentives to save doubled; taxpayers in the 25 percent bracket would see a moderate increase in their incentive to save, and the millions of Americans who have no tax liability would for the first time have a strong incentive to save beyond even the matching refundable tax credits on their initial savings.

Of course, under this system, those in the highest bracket would receive a credit less generous than their current deduction. Yet, academic evidence confirms that tax incentives are least effective in generating new savings among this highest bracket.[10] And while higher income earners would still

[8] This idea came out of a brainstorming session I arranged in June 2004 with Peter Orszag, Jon Talisman and Jason Furman

[9] Center for American Progress CEO John Podesta includes a similar proposal in his comprehensive Progressive Tax Reform plan that will be released later this month.

[10] See: Engen, Eric and William Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," *NBER Working Paper #8032*, December, 2000; Jane G. Gravelle, "Individual Retirement Accounts (IRAs): Issues, Proposed Expansion, and Retirement Savings Accounts (RSAs)," September 15, 2000; Orazio P. Attanasio and Thomas De Leire, "IRA and Household Saving Revisited: Some New Evidence," NBER Working

receive a generous 30 percent credit on savings, it is worth considering why those in the top income bracket – the wealthiest 0.5 percent-1 percent of taxpayers – who are already saving the most, should receive a more generous incentive to save than the people who work as their personal assistants or who clean their offices? (Indeed, such a flat tax incentives for retirement savings would further spread wealth creation if it was extended to a similar 30 percent refundable tax credit for housing if the offsets could be found.)

Financing a Universal 401(k): a 5000-to-1 Tax Cut: The ambitiousness of a Universal 401(k) – both in terms of the generosity of matching funds and the transition to a flat tax incentive system for retirement savings – would depend on the willingness of the Congress and White House to find appropriate offsets. While the proposal, and particularly the matching funds to low-income workers, could certainly be justified without offsets because of the positive contribution to national savings it would make by leveraging in additional private savings, exceptions to pay-as-you-go principles will generally do more harm than good for overall national savings.

The cost of financing a Universal 401(k) with generous government matches would depend greatly on the take-up rate. If 60 million Americans leveraged $600 of refundable tax cuts a year, the costs would be $36 billion. And while the flat tax incentive would be primarily paid for by the savings from eliminating tax deductibility, it would require additional funds as well. Much of these costs could be covered, however, by allowing the estate tax exemption – currently at $3 million per couple – to rise to $5 million or $7 million as it is scheduled to do in 2009, while avoiding outright repeal of all estate taxes on the wealthiest estates. Allowing for zero taxation on estates up to $5-7 million per couple would only affect about 10,000 estates a year, yet could raise between $460-$600 billion from 2014-2023.[11] If these funds were used to provide even 50 million Americans greater tax incentive for savings, *it would mean that for every wealthy estate that would see higher taxes than under complete repeal, 5,000 Americans would get a tax cut that could help them someday build an estate of their own*.[12]

A Universal 401(k) Could Strengthen the Existing Employer-Based System with Steps to Make Savings More Automatic: Universal accounts would not require a separate bureaucracy or brand new instruments. Instead Congress could simply require that in order for private-sector sponsored accounts to receive matching refundable tax credits from the government they would have to assure that the initial contributions and government match were invested in a range of broad-based index or investment options. Additional options Congress could consider would be to set a limit on administrative costs – at least for accounts below a certain level – or to expand the Thrift Savings Plan now used by federal workers, which offers similar broad-based investment options and has

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Paper No. 4900, 1994, and Eric Engen, William G. Gale, and John Karl Scholz, "Do Savings Incentives Work?" *Brookings Papers on Economic Activity*, 1994.

[11] The Center on Budget and Policy Priorities estimates that retaining the estate tax at $3.5 million per individual would, in 2010, affect only 10,000 estates in the US, less than one half of one percent of all projected deaths in that year. "Permanent Repeal of the Estate Tax Would Be Costly, Yet Would Effect Very Few Estates," 06/17/03.

[12] If additional savings beyond the retention of a $5 million estate tax exemption were needed to cover the full costs of a generous Universal 401(k) plan, the government could transfer savings from the closing of egregious international corporate loopholes, including those provisions in our tax code like the so-called "deferral provision" that provide an affirmative incentive for companies to locate production overseas.

proven highly efficient in keeping administrative costs low.[13] Given the importance of encouraging more savings and wealth creation for retirement, withdrawals from the Universal 401(k) accounts would be restricted to retirement, with exceptions only for a down-payment on a first house or major education expenses. One major issue worth exploration is whether limited withdrawals should be allowed during periods of long-term unemployment.

Portability Would Provide a Plus for Parents Balancing Work and Family: The Universal 401(k) would be completely portable and not limited to being administered by an employer. This means a worker would be able to maintain his or her account for their entire lifetime and continue to receive savings incentives when changing jobs or taking time off to raise children.[14] One of the key barriers to sustained savings for families is that parents who decide to take time off lose the opportunity to contribute to – and receive a match from – an employer-sponsored plan. The Universal 401(k) ensures that families where a parent – often the mother – stays home to care for children gets the same rewards for savings as other families.

Universal 401(k) Plans Should Encourage Automatic Enrollment: The government could take other important steps toward a Universal 401(k) by encouraging more companies that offer 401(k) plans to automatically enroll their workers in the plans.[15] Under the current system, the default for 401(k) plans is non-participation – new employees entering firms need to affirmatively decide they want to participate or else they will not be enrolled. An employee who is unaware of the benefits of participating in a 401(k) plan, wary of forfeiting money from her paycheck, or simply forgets to fill out the paperwork, will end up outside the powerful savings system that 401(k)s provide. To address this, a small but growing number of companies – about 8 percent of those that offer pensions[16] – have adopted so-called "auto-enrollment" programs where all new workers by default, contribute a certain percentage of their income (usually about 3 percent) into a 401(k) unless they chose not to participate. The default investments are conservative, usually money market funds or diversified mutual funds. The results from these auto-enrollment programs have been highly promising, with participation rates jumping from 29-30 percent to 86-96 percent within a short period of time.[17] Perhaps even more encouraging, a recent National Bureau of Economic Research Paper found that the impact of auto-enrollment for lower-income workers appears to be enormous: among workers earning less than $20,000 a year, auto-enroll programs raised participation rates from 12.5 percent to 79.5 percent. The increases from automatic enrollment were the most significant for low-income, black and Hispanic, and younger workers.[18]

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[13] The average administrative expenses in a Thrift Savings Plan fund is 10 basis points (0.1 percent). This compares to an average of 94 basis points charged by private mutual funds, according to the Securities and Exchange Commission. See: www.tsp.gov/rates/fundsheets.html and www.sec.gov/news/studies/feestudy.htm.

[14] The full portability of Universal 401(k)s would also help workers in consolidating employer provided pensions by offering a single constant account that employees could roll all of their assets into every time they changed jobs.

[15] For a more detailed explanation of the design and impact of automatic enrollment plans, see: Orszag, Peter and William Gale. "Private Pensions: Issues and Options," in Agenda for the Nation. *Brookings University Press*, 2003; Orszag, Peter. "Bolstering Retirement Security," 10/13/04 and Purcell, Patrick. "Automatic Enrollment in Section 401(k) Plans," *Congressional Research Service*, 10/14/04.

[16] Purcell, Patrick. "Automatic Enrollment in Section 401(k) Plans," *Congressional Research Service*, 10/14/04. p. 1.

[17] Choi, James, David Laibson, and Brigitte Mandrian, "Saving for Retirement on the Path of Least Resistance," July 19, 2004.

[18] Madrian, Bridgette. "The Power of Suggestion: Inertia in 401(k) participation and Savings Behavior," *NBER working paper 7682*.

In addition to auto-enrollment, a number of companies have also begun to experiment with ways of making it easier for employees to automatically link contribution increases to salary increases, to ensure that the level of savings do not stagnate. Economists Richard Thaler and Shlomo Benartzi have created the "Save More Tomorrow" program which asks employees before a scheduled raise if they would like to automatically link their retirement savings contributions to their salary going forward. Pilot programs in a number of companies have produced positive results, with the savings of program participants increasing from 3.5 percent to 13.6 percent in less than four years.[19]

Allow Workers to Split Tax Refunds for Savings: The government could also make it easier for lower income workers to directly deposit their tax refunds, like the Earned Income Tax Credit and the Child Tax Credit, into tax-deferred retirement savings accounts by simply checking a box on their tax returns. This is an idea that former Chief Pension Expert at the Department of Treasury Mark Iwry has championed and others including Lily Batchelder and Fred Goldberg of Skadden Arps and Peter Orszag and William Gale of the Brookings Institution have helped develop in detail.[20] Under current law, taxpayers who want to do this are given an all-or-nothing choice: either deposit all of their refund into savings or nothing at all. Hard-pressed families may understandably feel some reluctance at directing all of their refund towards a savings account when they might be struggling to pay their bills. In test programs, participants given the choice to "split" their refunds ended up saving 47 percent of what they received.[21] We could even go further and sweeten the deal with a small government bonus match for families who chose to direct a substantial portion of their refund to savings.[22]

<u>2. MUTUAL SACRIFICE AND RESPONSIBLE FINANCING</u>:

The second test that progressives should insist on in considering Social Security reforms is that any viable proposal should embody the principle of mutual sacrifice. Americans are likely to support sacrifices and hard choices to reform Social Security if they are convinced that Congress and the White House have simply no other options in order to keep Social Security solvent. Yet how can the president ask any portion of today's Social Security's taxpayers or tomorrow's Social Security recipients to accept sacrifice, when the long-term cost of his tax cuts for only the top 1 percent of earners is enough cover the entire 75-year Social Security shortfall projected by the Congressional Budget Office.[23]

[19] Benartzi, Shlomo and Richard Thaler. "Save More Tomorrow: Using Behavioral Economics to Increase Employee Saving." *Mimeo*, July 2003.

[20] See: Gale, William, J. Mark Iwry, and Peter Orszag. "Savers Credit: Issues and Options," 05/03/04.

[21] Beverly, Sondra, Daniel Schneider and Peter Tufano. "Splitting Tax Refunds and Building Savings: An Empirical Test." November 2004.

[22] For example, the government could offer families receiving a $1,000 child tax credit a $100 "bonus" in their savings account if they directed the entire credit into an IRA or their Universal 401(k); though not necessarily if the full matching credits from a Universal 401(k) were already in place.

[23] The Center on Budget and Policy Priorities has estimated that the present value cost of the tax cuts for the top 1 percent of earners over 75 years is 0.6 percent of GDP, well above the Congressional Budget Office's 0.4 percent projection of the 75-year shortfall in Social Security and nearly equal to the Social Security Trustees' projected shortfall of 0.7 percent of GDP. "The implications of the Social Security Projections Issued by the Congressional Budget Office," *CBPP*, 06/14/04.

Progressives should insist that any financing plan to address Social Security's shortfall contain a significant contribution from these top 1 percent of earners – who have just benefited so greatly from the president's tax cuts – as a pre-condition for a bipartisan agreement. The best option would be for the president to propose a 3 percent surcharge on all income over $200,000 – whether from income, dividends or capital gains – with the funds dedicated to both increasing national savings now and directly linked to increasing Social Security solvency. The president could make the deal contingent on a bipartisan agreement to find equivalent savings to shore up Social Security through measured revenue and benefit changes. We estimate that the 3 percent surcharge would reduce the projected 75-year Social Security shortfall by approximately 0.6 percent of payroll, enough to close more than half of the shortfall projected by the Congressional Budget Office. (Both the surcharge and the accompanying savings could be increased to cover the larger shortfall projected by the Social Security Trustees).[24]

The 3 percent surcharge on all income over $200,000 is preferable to other ways of asking for mutual sacrifice. It has two significant advantages over even the politically courageous proposal put forward by Sen. Lindsey Graham (R-SC) to raise the cap on payroll taxes from $88,900 to as high as $200,000. First, by placing the surcharge on all income, it does not penalize upper middle class and high income wage earners over those with capital investment, nor create distortions of incentives to engage in tax strategies to turn wage income into dividends or capital gains to avoid payroll taxes. It also is more progressive – particularly for the self-employed. The surcharge would affect only about 2 percent of taxpayers, and it would only be a 3 percent levy on income above a high threshold – not even as much as recent tax cuts that this income group has received. On the other hand, raising the cap could apply an additional 12.4 percent tax on the self-employed – a sizeable increase for someone making $140,000. Even for those simply paying the employee side of the payroll tax, many economists argue that over time the entire payroll tax increase would eventually fall on the employee.

Were President Bush to come forward with a financing element of this nature and a proposal for individual accounts outside of Social Security, it would be incumbent on Democrats to work together with Republicans to find equivalent savings. While raising the amount of wages covered by payroll taxes as Senator Graham and others have proposed could be a part of this package, the 3 percent surcharge would make it easier to have a lower rate applied to the extended income limits if there was bipartisan agreement on this option.

3. MAKE REAL PROGRESS ON NATIONAL SAVINGS AND GENERATIONAL RESPONSIBILITY:

The third principle is to firmly re-commit to the long-held consensus that any reform plan should meet the test of "generational responsibility" by increasing national savings now.
For years, policymakers of all political stripes have agreed on the principle of generational responsibility – the obligation of the current generation to make necessary sacrifices to offer the

[24] The Social Security Trustees report in 2004 project ed the 75-year Social Security shortfall at 1.89 percent of taxable payroll, while the Congressional Budget Office in June 2004 projected the shortfall at 1.0 percent of taxable payroll. The divergence between the two projections is largely explained by differences in economic assumptions and methodological approaches. For more detail on the differences, see: "The Implications of the Social Security Projections Issued by the Congressional Budget Office," *CBPP*, 6/14/04.

next generation a more productive and prosperous future. The one thing nearly everyone in Social Security circles until recently agreed on was that, as we moved closer and closer to the baby boom retirement, this need for generational responsibility took on a new, urgent importance. A core motivating factor behind previous entitlement reform efforts and Presidential Social Security Commissions was the notion that we had to improve national savings and fiscal discipline today to ensure that we were putting our economy and government finances in a better place to deal with the baby boom retirement down the road.

This commitment to generational responsibility was embodied in President Clinton's plan to reduce deficits and save surpluses for Social Security and the bipartisan commitment to debt reduction in the late 1990s. Indeed, the improvement in the federal fiscal picture was solely responsible for a near doubling of net national savings over his presidency. While private savings fell sharply from 7.8 percent of GDP in 1992 to only 3.5 percent of GDP, the historic positive swing in public savings – from a deficit of 4.7 percent of GDP in 1992 to a record surplus of 2.4 percent of GDP in 2000 – not only offset this decline but drove an increase in net national savings from 3.1 percent of GDP in 1992 to 5.9 percent of GDP in 2000. Indeed, if private savings had remained constant over this eight year period, the government's commitment to fiscal discipline would have more than tripled national savings – from 3.1 percent of GDP in 1992 to more than 10 percent of GDP in 2000.

President Bush's departure from that consensus has been abrupt. While well-targeted and temporary consumption-oriented tax cuts may have made sense during the recent economic downturn, the administration's focus on large, long-term tax cuts with permanent costs has worsened the path of our nation's savings, and will end up draining trillions of dollars for decades and decades to come. The tax cuts, particularly in the face of overall spending increases, have already driven a dramatic fall in national savings in recent years from its high of 5.9 percent of GDP in 2000 to only 1.4 percent of GDP over the last seven quarters – its lowest level since 1934. The deterioration in the ten-year budget outlook driven by the Bush administration's tax cuts is even more striking. In early 2001, projections from both the Congressional Budget Office and the administration's own FY2002 budget suggested we would achieve $7.3 trillion in surpluses from 2005-2014.[25] Now, independent estimates from Goldman Sachs and others project $5.5 trillion in deficits over that period.[26] That is a nearly $13 billion swing – what former Nixon Secretary of Commerce Peter Peterson has called "the biggest, most reckless deterioration of America's finances in history."[27]

During a period when there should have been an increasingly urgent focus on the need to be saving more, the Bush administration's fiscal policy has taken us two giant steps backwards on national savings. In this light, it is absolutely imperative that any Social Security reform plan move national savings in the right direction.

Yet even after the recent deterioration in savings, some Republican Social Security proposals would go even further in the direction of recklessness by turning the entire notion of generational

[25] In January 2001's *The Budget And Economic Outlook: Fiscal Years 2002-2011*, CBO projected surpluses of $5.610 trillion between 2002 and 2011. The President's FY2002 budget – initially released in February 2001 and released formally in April 2001 – contained the same $5.6 trillion projection. Using a conservative assumption that the growth in surpluses would slow to only the rate of nominal GDP growth after 2011, this suggests cumulative projected surpluses between 2005 and 2014 of $7.3 trillion.
[26] "Fiscal Policy in the Second Bush Term," GS Economic Research, 11/03/04
[27] Peterson, Peter G. Running on Empty. *New York: FSG Press*, pp. xxv.

responsibility on its head. Rather than having this generation make the hard choices to save more and consume less in order to increase productivity and reduce the debt we leave to the next generation, these plans call for massive government borrowing today and pray for higher returns, while calling for zero savings or sacrifice either now or in the future. The most prominent of these "free lunch"
plans was originally designed by an Institute for Policy Innovation economist and introduced as legislation by Rep. Paul Ryan (R-WI) and Sen. John Sununu (R-NH). The plan is billed by supporters as an example of how you could carve out individual accounts and close Social Security's long-term financing gap without having to accept any benefit cuts or tax increases, either now or in the future. Yet to do so, the plan relies on massive government borrowing – $7 trillion in present value terms, or nearly twice the existing Social Security shortfall – and offers no credible suggestion on where such resources would be found, other than to suggest that future government spending could be cut. The Center on Budget and Policy Priorities has found that the plan would more than double the size of the US debt by 2030 to 144 percent of GDP.[28]
What is critical to recognize is that even beyond these completely "free lunch" plans, Social Security proposals that claim to "do no harm" to national savings by increasing borrowing now but calling for tax increases or benefit cuts down the road still fail the test of generational responsibility. While such proposals may be better for national savings than the most irresponsible plans, they cannot claim to measure up to the goal of actually improving savings now, and, particularly in the face of the giant steps backwards the Bush administration has taken in recent years, cannot be considered to be responsible approaches.

The most well-known plan put forward by the President's Social Security Commission – the so-called "Model 2" reform – is one such proposal. It calls for borrowing more than $2 trillion in the coming decade and substantially larger amounts in subsequent decades, but suggests options to cover this borrowing and the long-term Social Security shortfall by cutting future benefits. Offering a blueprint for the difficult choices that future generations will have to make may pass a political hurdle of having to specifically identify the pain you would suggest. But it is a long way from increasing savings today.

Indeed, one of the most distressing things about the fiscal policy climate in Washington today is that, where there was once a broad consensus that we should be increasing savings and where President Bush has already taken us giant steps away from that goal, the new policy gold standard seems to be policies that simply aim to do no harm to national savings.

Unfortunately, even the notion that these plans would do no harm is tenuous. First, plans that drive government deficits to record levels – as the president's own Council of Economic Advisers has acknowledged is the explicit design of carve-out accounts[29] – can have negative economic impacts if it leads to a loss of economic confidence and upward pressure on interest rates. As economists William Gale, Jason Furman and Peter Orszag have detailed in a recent paper, this new borrowing represents an explicit liability of the government which financial markets may react more negatively to than the implicit liabilities in the Social Security system, and which will restrict our fiscal

[28] William Gale, Jason Furman, and Peter Orszag. "Should the Budget Be Changed to Exclude the Cost of Individual Accounts?" CBPP 12/13/04.
[29] The 2004 Economic Report of the President 2004 found that "Personal retirement accounts widen the deficit by design — they refund payroll tax revenues to workers in the near term while lowering benefit payments from the pay-as-you-go system in later years."

flexibility in the face of economic challenges. "Financial markets" they explain, "are likely to recognize that the possibility of a crisis is higher with explicit debt than implicit debt; unfortunately, that recognition itself makes a crisis more likely."[30]

Second, huge borrowing can harm national savings by creating the precedent for the government avoiding hard choices. Such borrowing represents a tacit acceptance by today's lawmakers that they can do no better than the most irresponsible savings behavior today, and locks in that irresponsible behavior for decades to come. In this environment, we are likely to see the emergence of more "free lunch" Social Security reform plans and other budget gimmicks that allow lawmakers to continue skirting the responsibility to accept tradeoffs today. The results for national savings and our economy of such a deterioration of fiscal policymaking could be severe.

Restoring Generational Responsibility: Unlike carve-out account plans, the steps outlined in this paper would represent an important step in restoring the commitment to generational responsibility and increasing national savings now to increase productivity and better prepare us for the impending baby-boom retirement. The Universal 401(k) plan would be responsibly financed by providing offsetting savings, and would be designed to truly leverage new private savings by targeting generous incentives at those families currently saving the least. The new 3 percent surcharge would help to immediately increase national savings now, and, by providing the commitment to mutual sacrifice necessary for a bipartisan process, would help encourage additional steps to make real tradeoffs and increase savings.

4. COMMITMENT TO A TRUE BIPARTISAN PROCESS:

A Universal 401(k) alongside a willingness to call for mutual sacrifice and recommit to the principle of increasing national savings now could provide the substance for a deal on Social Security, which could not only garner broad bipartisan support but would increase ownership, savings and ultimately retirement security. But to make this happen, both President Bush and progressives must also recognize that the only times when Washington has been able to take on tough entitlement savings without painful political backlash was when there was a sustained commitment to work with the opposing leadership.

For the Bush administration, this means breaking from its established legislative strategy. Though successive rounds of tax cuts, the administration has consistently relied on what I have called the "Rightward Sweep,": start to the right and hope to get enough unified support in the House of Representatives to ram through your ideal legislation; the fake left in the Senate just enough to persuade a handful of Democrats to join, before cutting as far back to the right as possible in conference committee.[31] The move has been a fiscal disaster, but delivered consistent victories on the legislative front.

The problem on Social Security is that it is far less clear that Republicans will see it in their interest to run the "Rightward Sweep" even if they have the strength to execute it. Accepting a Social Security reform plan that includes painful benefit or tax changes (like the 26 percent - 46 percent

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[30] William Gale, Jason Furman, and Peter Orszag. "Should the Budget Be Changed to Exclude the Cost of Individual Accounts?" CBPP 12/13/04.
[31] This analysis was first presented and outlined in more detail in: Sperling, Gene "Bipartisanship on Social Security?" *Bloomberg Business News*, 12/29/04.

benefit cuts that would result from a proposal to switch from wage indexing to price indexing that the administration is rumored to be considering)[32] introduces significant electoral risk for any Republican seeking reelection. Indeed, every time painful entitlement reform has been passed in recent history without strong bipartisanship, there has been significant backlash.

Many Republicans felt they were punished at the polls in 1986 for floating painful Social Security options. Democrats who courageously voted -- without a single Republican vote -- for the 1993 deficit reduction are still attacked a decade later for a measure that increased taxation of Social Security benefits for the top 13 percent of recipients, even though the proceeds were used to protect Medicare from going insolvent and Ronald Reagan had signed a provision taxing a far larger number of recipients' benefits exactly a decade earlier.

On the other hand, in 1983 when Ronald Reagan and House Speaker Tip O'Neill appointed Alan Greenspan and Social Security legend Robert Ball to help them negotiate a true bipartisan Social Security plan, the resulting agreement included unthinkably politically painful provisions – including raising the retirement age. Yet the provisions were able to pass because Reagan and Democrat O'Neill provided bipartisan cover.

The same is true of the 1997 Bipartisan Balanced Budget Act, which included very serious Medicare solvency measures but was able to garner a majority of each party because it had the blessing of President Bill Clinton and House Speaker Newt Gingrich – together with Senate Majority Leader Trent Lott and Minority Leader Tom Daschle.

The only way that President Bush could avoid working with Democratic leadership without introducing potentially unacceptable electoral risks for his Republican allies would be to resort to an absolute free-lunch plan that relies on trillions in borrowing up front, offers no real savings other than the hope of higher returns, and prays that markets don't react negatively or demand higher interest rates. After taking us giant steps backwards on savings with tax cuts in his first term, an ideologically driven free-lunch financing plan to carve out private accounts could not only set-back savings and retirement security, but lock in the perception of fiscal recklessness and undermine confidence and economic growth.

Certainly we can do better than this. As the proposals in this paper illustrate, if political leaders are willing to commit to a bi[partisan process, they have the opportunity to increase savings, promote generational responsibility, and protect Social Security's guaranteed benefit, while more effectively spreading wealth creation opportunities among the American people.

[32] According to the Center on Budget and Policy Priorities the 26 percent reduction refers to a worker with average wages who retires in 2042; the 46 percent reduction refers to a child today who will earn average wages and retire in 2075. "So-Called "Price Indexing" Proposal Would Result In Deep Reductions Over Time In Social Security Benefits" *CBPP*, 12/21/04.

APPENDIX

Five Reasons Why a Universal 401(k) is Superior to Carving Out Private Accounts From Social Security:

1. A Real Increase in National Savings: A Universal 401(K) would virtually guarantee an increase in national savings. In contrast, carve-out individual accounts financed by borrowing may decrease national savings.

First, most Republican proposals rely on massive unspecified borrowing to cover the cost of their individual account plans, while the Universal 401(k) would be financed responsibly with specific savings to offset new costs, as explained above. Proposals to take a portion of the existing Social Security payroll currently designated to pay benefits of today's retirees and transfer it into individual accounts, create a substantial new hole in financing the promised benefits to current and future retirees. This is what is often referred to as the "transition cost" of carving out private accounts from the resources committed to paying Social Security benefits. The 2004 Economic Report of the President estimated that the transition cost of the primarily individual account proposal put forward by the President's Commission to Strengthen Social Security would be $2 trillion over the next decade.[33] The borrowing necessary to finance other Republican individual account plans ranges from $1 trillion to $5.3 trillion over ten years, and grows even higher in the following decades.[34]

Second, what is critical to understand is that even beyond the borrowing necessary to finance transition costs, carve-out individual account proposals do nothing on their own to help our nation save more. Taking a portion of the current 12.4 percent Social Security payroll tax and transferring it to private accounts does nothing to increase national savings. All it does is shift existing savings around. These proposals are the equivalent to taking $1000 a year from your parent's 401(k) and putting it in your own IRA. Your family has not increased its overall savings at all, you have simply shifted funds you were already saving from a lower- to a higher-risk account. When the Congressional Budget Office examined the impact of individual accounts after adjusting for the increased risk of allowing equity investments within Social Security, it found that no one is truly better off. Indeed, the CBO found that individual accounts could lead to behavioral responses that could actually reduce private savings.[35]

Other administration savings account proposals are also designed to *shift* existing savings rather than leverage new savings from the private sector. Consider the administration's proposal to create new tax-deferred Retirement Savings Accounts (RSAs) and Lifetime Savings Accounts (LSAs), which was included in both the FY2004 and FY2005 budgets. Currently only about 5 percent of people contribute the maximum amount allowable to IRAs and 401(k)s. The other 95 percent either

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[33] *Economic Report of the President,* Council of Economic Advisers, 2004. p. 144.
[34] William Gale, Jason Furman, and Peter Orszag. "Should the Budget Be Changed to Exclude the Cost of Individual Accounts?" CBPP 12/13/04.
[35] CBO, "Long-term Analysis of Plan 2 of the President's Commission to Strengthen Social Security," July 21, 2004,

can't afford to put away that much or have no retirement savings at all. Yet rather than focusing incentives on leveraging new savings from those 95 percent not saving enough, the primary thrust of the Bush administration's RSA and LSAs is to increase the amount of wealth that the fortunate 5 percent can shelter from taxation. The new accounts would remove existing income caps on tax-deferred IRA saving - which by definition would help only the currently excluded households that make more than $160,000 a year – and would raise contribution limits, which is largely irrelevant for those who cannot afford to save up to the existing contribution limit in the first place.[36]

Targeting new savings incentives at the fortunate 5 percent not only exacerbates the upside-down nature of our existing system of tax incentives, but it is extremely ineffective savings policy. Numerous studies have shown that offering high-income savers new incentives causes them to simply shift their existing savings to capture the tax windfall, rather than actually save more. When the Congressional Budget Office analyzed Bush's proposals in March 2003, it found that "most taxpayers would simply save the same amount in one of the new accounts as they would have saved in one of their current tax-free accounts." (On the other hand, the proposals would have a dramatic negative impact on public savings over the long-term, opening up a new budget hole one-third the size of what it would cost to make Social Security solvent for 75 years.)[37]

A Universal 401(k) that targeted generous new incentives at those families having the hardest time saving would have the opposite impact. Government matches for low- and moderate-income families would be encouraging families that are currently not saving at all to undertake new savings, and those who are currently saving too little to actually increase the amount that they save. In this way, the core components of the Universal 401(k) are set-up to leverage the maximum amount of new savings from the private sector for every dollar of government funds committed to savings incentives.[38]

<u>2. Increases Ownership and Investment without Adding Risk to the One Risk-Free Leg of Retirement Stool</u>: It is a long-held axiom that retirement security should be seen as a three-legged stool: pension, private savings or home equity, and Social Security. The first two legs both subject future retirees to considerable market and economic risk. While almost everyone would agree that the potential benefits of higher returns justify some balanced long-term investments in the market, why add market risk to the one leg of the retirement stool that is guaranteed? Why not keep Social Security risk-free while helping all American workers save and invest more as part of the pension leg of the retirement stool?

<u>3. Prevents Fear of a Slippery Slope</u>: Much of the skepticism of Republican carve-out account proposals is a perception that the real motivation behind creating accounts with a small portion of the payroll tax today, is to take a first step down a slippery slope where eventually individual private accounts will entirely replace Social Security. Progressives are justifiably concerned that

[36] The Bush Plan would allow a family of four that was currently "maxing out" their IRA accounts at $4,000 apiece to now put away $30,000 in tax-deferred savings each year, if the parents put $5,000 apiece into RSAs and $5,000 for themselves and their kids into the new LSAs

[37] Orszag, Peter. "Progressivity and Saving. Fixing Our Nation's Upside-Down Incentives for Saving," *Testimony before the House Committee on Education and the Workforce*, 02/25/04.

[38] These dramatic differences in design suggest that even if you were to consider a fiscally irresponsible private account plan that relied solely on government borrowing and included no offsets, you would want to favor a plan designed like the Universal 401(k), which would itself generate new savings from the private sector.

partial privatization proposals are specifically designed to make individual accounts seem more attractive while downplaying the guaranteed benefit structure of Social Security – which includes survivor and disability benefits – to superficially undermine the broad-based political support for a progressive benefit structure that has served both the middle class and poor seniors for generations.

A Universal 401(k) that promotes ownership outside of Social Security would show progressives that the push for individual account was truly about increasing individual savings and wealth creation, not just undermining Social Security's progressive guarantee. It is worth noting that the Democratic and Republican co-chairs of President Bush's Social Security Commission the late Senator Daniel Patrick Moynihan and AOL Time Warner COO Richard Parsons explained, in the introduction of their report that one way forward could be to "establish an opportunity for all people with earnings to set up a personal retirement account. These accounts could be financed by the individual worker voluntarily adding one percent of his pay *on top of* the present 6.2 percent employee share of the Social Security payroll tax. The Federal government could match the employee's contribution with one percent of salary, drawn from general revenues. *The result would be retirement savings accounts for all participating American workers and their families, which might or might not interact directly with the Social Security system*."[39] [emphasis added] Social Security legend, Robert Ball has also endorsed the idea of personal accounts outside Social Security as a "highly desirable" way to increase savings and retirement security.[40]

<u>4. Offers Inheritability Without Adding Market Risk:</u> Individual account supporters often argue that an advantage of carving accounts out of Social Security is that if a worker dies at an early age, he can bequeath the balance of the account to his or her heir. These advocates seem to suggest that the only way to achieve inheritability would be to carve up Social Security.

This argument is completely without merit. If we wanted to offer an additional inheritability benefit within Social Security, we could simply legislate it into Social Security as we know it today without partially privatizing the system and adding market risk. But one must acknowledge that this would add real additional costs. Social Security functions like an annuity, meaning that you get a certain amount each month for as long as you live. If someone lives longer than average, it turns out to be a better deal to that person but more costly for the Social Security system. On the other hand, if a person dies sooner than average, Social Security is a worse deal for that person, but the savings to the Social Security system compensate for the costs of the people who live longer. For the growing number of older women who outlive their husbands and live into their 90s, the annuity-like design of Social Security is literally a lifesaver and critical to avoiding poverty in retirement.

The critical point here is that carve-out accounts alone do nothing to promote inheritability, which could be done just as easily through Social Security. The real issue is cost, and whether ultimately it makes sense to do anything other than encourage the use of annuities for retirement savings.

<u>5. Universal 401(k) Can Work With and Reinforce the Existing Employer-Provided System</u>: If designed correctly, a Universal 401(k) could help to encourage more employers to offer retirement plans to their employees and help strengthen the employer-leg of our retirement stool. Workers eligible for matching credits under the Universal 401(k) that also have employer-sponsored

[39] Report of the Commission to Strengthen Social Security, December 2001. p. 8.
[40] Ball, Robert. "Social Security *Plus*," 2004.

pensions would be able to receive the government match on savings contributed into either account. This would ensure that the new savings incentives offered through the Universal 401(k) did not provide a disincentive for employees to participate in their employers plans. In fact, because the Universal 401(k) targets incentives at lower- and moderate-income workers and is likely to increase savings most among these groups, the plan could help more employers meet so-called 'non-discrimination' rules, which require the participation of a majority of lower-income employees in 401(k) plans before employers can offer retirement benefits to higher-compensated employees. This would give employers a new incentive to offer retirement plans to their workers and to offer the type of automatic deduction options that have shown to be so successful in increasing participation in retirement saving accounts.[41] Carve-out accounts, on the other hand, would add risk and new transaction costs to Social Security, while doing nothing to shore up the employer-provided pension system.

[41] While the Universal 401(k) could provide new incentives for employers to cover their employees, it also offers sustained savings incentives for workers if their companies stop offering matching contributions because of financial stress. In the most recent downturn, employer 401(k) matching contributions fell from 3.3 percent to 2.5 percent of workers pay between 1999 and 2001, and many companies, including Charles Schwab Corp., Goodyear and Ford at least temporarily dropped matches. A Universal 401(k) plan would ensure that workers would have steady incentives to maintain a pattern of saving and investing even when employers cut back.

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