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More Pain, No Gain: Breaux Plan Slashes Social Security Benefits Unnecessarily

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Neither the Breaux plan nor President Clinton's proposal for "saving" Social Security promises much gain, but the Breaux plan, unlike the president's proposal, would inflict real pain in the form of reduced benefits.

The Bipartisan Social Security Reform Plan, which would purportedly rescue Social Security, was unveiled on May 20 by Senators Judd Gregg (R-N.H.), John Breaux (D-La.), Bob Kerrey (D-Neb.), Charles Grassley (R-Iowa), Charles Robb (D-Va.), Fred Thompson (R-Tenn.), and Craig Thomas (R-Wyo.). At a national press conference, Senator Breaux called the proposal "a comprehensive, fiscally responsible plan that saves Social Security for future generations." According to Breaux, Social Security can be kept solvent for more than 75 years, with no payroll tax increase, by privatizing part of the program, and privatization will "strengthen the safety net provided by Social Security, while at the same time providing Americans with more investment opportunities and retirement choices." The plan would also create government-subsidized savings plans for young children, which could be rolled into Social Security "to serve as a nest egg for each worker's retirement."

All of this seems rather appealing—all gain, no pain. Such a simple solution for the "looming Social Security crisis" must make one wonder why there has been so much fuss in recent months. However, a closer look at the plan (hereafter called the Breaux plan) reveals lots of pain as the supposed gains evaporate. As usual, the devil is in the details. It turns out that the plan is anything but simple; it contains a large number of major changes to the Social Security program that will have a large and quite complex impact on its costs and revenues. Based on the information provided to date, it is impossible to verify whether these changes will indeed eliminate projected financial shortfalls. However, of greater concern is the long list of benefit cuts that have been slipped into the proposal. While the sponsors would have us believe that the shortfall has magically been resolved by allowing workers to divert 2 percent of payroll taxes into individual retirement savings accounts, we suspect that most of the financial improvement comes from benefit cuts and a diversion of projected general budget surpluses to Social Security.

In this note we compare the Breaux plan with President Clinton's proposal, which also relies on a diversion of surpluses. Although we aver that Social Security is not facing a crisis, we conclude that if it were, neither plan would provide much gain, but the Breaux plan, *unlike* the president's proposal, would inflict real pain in the form of reduced benefits.

The Clinton Proposal

The Clinton proposal would "lock away" in the Social Security Trust Fund over 60 percent of the general budget surpluses projected for the next 15 to 25 years. About 80 percent of the surpluses allocated to Social Security would be used to purchase Treasury securities and the remaining 20 percent would be invested in an index of private sector securities. What it all boils down to is this: If the general budget can run surpluses as projected (a big "if," by the way), Treasury debt held by the public will be retired. Each year an amount of new Treasury debt equal to 60 percent of the retired debt will be issued to the Trust Fund; interest paid on this debt will be added to Social Security payroll tax revenues. When Social Security revenues fall short of expenditures, the Trust Fund will turn bonds back to the Treasury to cover the difference. The Treasury, in turn, will have to issue new debt or raise taxes at that point in order to retire the debt held by the Trust Fund. In addition, the Trust Fund can begin to sell its portfolio of private equities. According to President Clinton, his plan will extend Social Security's solvency through 2055.

The president's plan relies on 80 percent accounting sleight of hand and 20 percent gambler's lucky draw. "Locking away" surpluses in the Trust Fund is pure accounting fiction—a surplus is not something that can be "saved." The projected surpluses have nothing to do with "saving" Social Security except to give a number to be used to calculate how much new debt should be created that the government can owe itself. The president could just as easily have proposed that we create a nonmarketable Treasury liability equal to the entire discounted Social Security shortfall, stick that in the Trust Fund today, and thereby save Social Security forever.

The new bipartisan plan mixes financial fixes with more serious consequences for the unlucky and real benefit reductions for most retirees.

Moreover, purchasing private equities as a means of accumulating a large trust fund is a risky proposition. First, as many commentators have noted, it seems quite unlikely that the stock market will continue to perform as well as it has over the past 75 years (earning average real returns of 7 percent a year) with the economy projected to grow at far less than half the rate it has averaged over that same period. Second, the performance of the stock market varies considerably over fairly long periods, and it could very well be in a phase of low returns precisely when the Trust Fund needs to sell equities. Demographics make this unfortunate event quite likely. The Trust Fund and the private pension plans will all be selling assets at the same time to provide retiring baby boomers with pensions.

Finally, and most importantly, improving Social Security *finances* does not relieve the real burdens that may be placed on future workers to provide for retirees. Tomorrow's workers will have to produce all the goods and services that will be needed by tomorrow's retirees. Sales of Trust Fund assets to provide monetary benefits to tomorrow's retirees do not directly increase the flow of goods and services going to them. The sales might just depress asset market prices, and spending by retirees of their benefits might just cause inflation of the prices of goods and services. The most direct and certain way to shift distribution of consumption toward tomorrow's retirees is to raise taxes on tomorrow's workers *at the time the shift is desired.*

The one compliment we can pay to the Clinton plan is to say that while it provides little gain, it inflicts little pain. Clinton did not propose any benefit reductions or tax increases.

The Breaux Plan

The Breaux Plan has three main components: partial privatization, a government-subsidized savings plan, and benefit cuts with tax hikes.

The plan allows for private fund management of the portion of payroll taxes that will flow into the stock market. This windfall for Wall Street will reduce net earnings by the amount of the fees paid to the private managers. Furthermore, while giving workers greater control of funds through private accounts, the plan leaves workers at the mercy of the performance of their portfolio. An individual's Social Security benefits will be reduced by an amount equal to what he or she would have earned if the funds in the private account had been invested in T-bills. Those whose portfolio does better than the T-bill rate reap the benefits. Those unlucky souls whose portfolio under- performs the T-bill rate suffer the consequences.

The Breaux plan also creates a voluntary personal savings account with a progressive matching fund program. Essentially, the government will contribute to each worker's personal savings account up to 1 percent of the current taxable wage base annually (the taxable wage base is now $72,600, so the maximum matching contribution from the government would be $726 for 1999). Each worker may contribute another $2,000 annually to his or her personal account. The account then supplements Social Security benefits upon retirement (with deductions to these benefits as for the private portfolios discussed above). Instead of government contributions to voluntary personal savings accounts of adult workers, we would prefer increases in benefits paid to low-income Social Security recipients.

The Breaux plan also includes KidSave accounts, which are similar to the Universal Personal Capital Account for Youths proposed by Robert Haveman (1988). Children born after 1995 would receive a $1,000 personal account at birth, with another $500 added for each of the first five years of life (for a total government contribution of $3,500). In general, we find little in the KidSave proposal to criticize—except that we would rather that the account could be used during those critical first five years. It would be preferable to provide a spendable "child allowance" at birth in an effort to reduce child poverty than to provide an account that cannot be used until retirement. Virtually all developed countries have a child allowance for all children to help support them in their formative years. In 1991 (the most recent year for which comparable data are available) the United States had the highest child poverty rate among developed countries and that rate was more than half again higher than the second highest rate, for Canada (Jäntti and Danziger 1999); in 1997 the poverty rate for U.S. children was 19.9 percent (U.S. Department of Commerce 1998).

Cutting benefits over the next few years simply lowers living standards prematurely without in any way reducing burdens on future workers.

Finally, the Breaux plan raises taxes and cuts benefits. The primary tax increase that we have been able to deduce from the information supplied thus far results from the slower growth of the inflation index applied to tax schedules. In other words, workers will be subject to "bracket creep" because the tax schedules will not be indexed fully to the consumer price index.

This is a tax increase, in spite of the claim by the plan's backers that payroll taxes are not increased. (If it walks like a duck and quacks like a duck, it ought to be called a duck.)

Of greater concern than this tax increase are the large benefit cuts. First, the plan would slash cost-of-living adjustments so that benefits would not increase as fast as the CPI. As is well known, the Boskin Commission argued that the current methodology used to calculate the CPI tends to generate an upward bias relative to some true measure of inflation or the cost of living. Many have quarreled with the commission's findings, with some commentators suggesting that the CPI might actually underestimate the cost of living increases experienced by some groups in society. We believe that these issues must be resolved before it can be decided if Social Security benefits should be subjected to lower cost of living increases.

Second, the plan would extend the number of years of earnings used to calculate benefits from 35 to 40 years, and, third, it would lower benefits as projections of life expectancy rise. These changes add up to significant cuts in benefits. Increasing the years of earnings used in calculating benefits from 35 to 40 years would significantly reduce average earnings for most workers. While the Breaux plan would allow five "dropout years" to the individual with lower earnings in every two-earner couple (which will help couples in which one partner takes time away from work to raise children), many families will suffer a net reduction of benefits. Similarly, raising the retirement age is equivalent to a benefit reduction. Under current law retirement age with full benefits will be 67 by 2022; under the Breaux plan it would rise more quickly, to 6.7 by 2011. Many elderly will want to work well past age 65 or 67, but others will find this difficult because of poor health or an unreceptive job market for the elderly. We endorse the Breaux plan's elimination of the earnings test so that the elderly can continue working if they desire, but we see no justification for automatic reductions of benefits as life expectancy rises.

It is the Breaux plan's tax increases and benefit slashes that are the real source of any improvement in Social Security's financial solvency that could result from the plan. It brings far more pain than Clinton's proposal and still no real gain. Like the president's plan, it attempts to resolve a crisis that may never arise and demonstrates little understanding of the issues at hand, focusing only on financial aspects. The president's plan seeks a solution through accounting manipulation and luck; the new bipartisan plan mixes financial fixes with more serious consequences for the unlucky and real benefit reductions for most retirees.

Conclusions

Social Security does not face a crisis now or in the future, so it is premature to slash benefits. We believe the Trustees have used overly pessimistic assumptions to project program revenues and expenditures, but even on the basis of those pessimistic assumptions, Social Security revenues are sufficient to meet costs far into the future. If just a handful of important economic and demographic variables return to their long-run trends, Social Security will remain solvent even past the 75-year period used for the long-range forecasts. However, if the future turns out to be as bad as the Trustees expect, relatively minor adjustments can be made 25 or 35 years down the road. It must be remembered that the projected gap between Social Security revenues and expenditures grows to only a little over 2 percent of GDP by 2075. In other words, the total shift of society's output that will be required to resolve the future "crisis" is only 2 percent of output. Shifts like this have been accomplished in the past without generating economic crises. Finally, there is little that can be done today to solve a problem that might arise 35 years into the future. The prudent course of action is to leave Social

Security alone until changes have to be made. If it turns out that more of society's output has to be shifted to retirees in 2035, then the most effective and most direct method of achieving that shift of distribution will be to use the tax system in the year 2035 to do so. Cutting benefits over the next few years simply lowers living standards prematurely without in any way reducing burdens on future workers.

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