

ECONOMIC VIEWPOINT

By Glenn Hubbard

# How Bush's Plan Would Secure Social Security

## Funding a personal account is like prepaying a mortgage

President George W. Bush has promised that Social Security reform will be a domestic priority over the next four years. It's a top priority because the oldest baby boomers will start to retire at the end of the President's second term. The President has proposed "personal accounts" in which you could deposit a portion of your current payroll tax into an investment account you would actually own. Unlike Social Security, you could pass this asset onto your heirs. At the same time, most of the current payroll tax would continue to fund traditional Social Security benefits to current retirees.

This reform would strengthen opportunities to build wealth for millions of Americans, many of whom have few financial assets today. Personal accounts also offer a surer way to prefund our obligation to pay future Social Security benefits. While lawmakers find it difficult to "save" rather than spend Social Security surpluses (the excess of current payroll tax over current benefits), personal accounts would be off-limits to politicians. The emergence of Social Security reform as a domestic policy priority is encouraging, but the focus on personal accounts raises both challenging questions and questionable challenges that need to be addressed.

**CHALLENGING QUESTIONS.** To start, what are the objectives of Social Security reform? One obvious objective is to advance the President's ownership society agenda. The transition costs to personal accounts will actually put Social Security on a firmer footing. As long as future net obligations are reduced by prefunding Social Security benefits through personal accounts, the diversion of a portion of payroll taxes to personal accounts is akin to prepaying part of a mortgage. If the transition costs are borrowed, the resulting higher explicit federal debt in the near term is offset by lower implicit debt (Social Security obligations) in the longer run. The present value of Social Security's unfunded liabilities is lowered.

This point relates to the second challenging question. Will the reform put Social Security on a better financial footing? The long-term funding gap facing Social Security is large because promised benefits exceed payroll tax receipts by trillions of dollars. Personal accounts alone will not secure Social Security's long-

term financial future. The President has stated that there would be no change for current retirees or those nearing retirement. Hence, to close the gap without raising taxes, younger workers will need to receive lower benefits relative to their previous earnings than today's retirees do.

Under current law, initial benefits are indexed to average wage growth in the economy during the years that the retiree worked. Since young workers start their careers at a higher wage level than older workers, they get a larger Social Security benefit in real terms when they retire. One reform plan that replaces this wage indexing with price indexing eliminates almost all of the unfunded liabilities of the system. Benefits received relative to wages would decline (along with Social Security's liabilities), but they would be supplemented by expanded savings from the personal accounts.

**QUESTIONABLE CHALLENGES.** Some critics argue that personal accounts would expose workers to too much risk, and administrative costs would fritter away account balances. But personal accounts could be invested in a mix of inflation-indexed Treasury bonds and broad stock portfolios to keep risk low over the long run. If investment choices are limited to bond and stock-index funds, administrative costs will be very low. The government could pay for such costs in the beginning.

Won't personal accounts limit Social Security's ability to make transfers from higher-income to lower-income workers? Not necessarily. One plan for Social Security reform would be to build in a higher ratio of benefits to wages for lower-income workers than higher-income workers. A proposal by Robert C. Pozen, Sylvester J. Schieber, and John B. Shoven would strengthen benefits for low-income retirees and reduce Social Security's unfunded liabilities by more than 70%.

Reform can deliver individually owned retirement accounts, a more stable future for Social Security, and a continued commitment to low-income seniors. These issues may well dominate the domestic policy debate once President Bush reveals his plans.

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