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ECONOMIC VIEWPOINT

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Social Security: Beware Of Hasty Compromises

"Add-on" accounts are a good idea, but not higher payroll taxes

Compromise is an important element of a lively policy debate. And reform of Social Security is topic No. 1 for domestic policy in Washington. President George W. Bush is saying that Social Security's unfunded liabilities are too large to ignore and that individually owned personal accounts offer an important path for America to save. The national conversation over Social

Security is already shifting to compromise, focusing on raising the cap on wages subject to the payroll tax and proposing "add-on" instead of "carved-out" personal accounts.

Raising the payroll tax cap is a bad idea. Proposals that suggest increasing the taxable wage base from \$90,000 to, say, \$150,000 would impose a 12.4% increase on the marginal tax rates of millions of Americans. These higher rates would offset the gains from President Bush's reductions in marginal income tax rates. A payroll tax hike would discourage work and entrepreneurship and would hamper job creation.

PAYROLL TAX INCREASES are unlikely to correct either the country's low savings rate or the need to shore up Social Security. An earlier tax increase -- based on the recommendation of the 1983 Social Security Commission chaired by Alan Greenspan -- raised the Social Security surplus, but those surpluses were not saved by Congress. The money was spent. Personal accounts offer a specific way in which Social Security contributions can be preserved.

The most compelling reason to avoid increasing the payroll tax is that the current structure of Social Security taxes and benefits is not a good deal for workers and retirees. Payroll taxes are high on young workers, and the promised benefits for older workers constitute essentially nonmarketable assets. Individually owned personal accounts are a better deal. Nearly 20 years ago, Kenneth L. Judd of Stanford University and I estimated that households might be willing to pay to opt out of these constraints of traditional Social Security. More recent research by economists Erik Hurst and Paul Willen of the University of Chicago quantifies that rational individuals would be willing to pay as much as 7.5% of their lifetime consumption to get out. That number is high because the constraints of the current system are painful and because Social Security is a major asset for many Americans.

Putting Social Security on a viable long-term financial footing could be better accomplished by slowing the rate of increases in Social Security benefits. Under the current system, initial Social Security benefits are indexed to average wage gains across the economy. A shift to price indexing would achieve financial soundness and reduce the

system's unfunded liabilities by trillions of dollars. To ease the pain on lower-income individuals, the burden of that adjustment in traditional benefits should be shifted to higher-income individuals who could use savings incentives, such as the President's proposed Retirement Savings Account, to save more for their retirement. Those savings could fund investment and growth.

Add-on accounts, however, should not be dismissed. If personal accounts alone were used to save Social Security, then one would clearly want to cut traditional benefits commensurately to compensate for them. But Social Security's fiscal problem is deeper than that. Benefits in the future must be increased more slowly than wages or the system's solvency cannot be restored. If we don't increase payroll taxes, solvency can be restored only by shifting from wage indexing to something else, such as price indexing.

An add-on personal account can make sense. Tax-free add-ons would decrease government revenue in the near term, but the deficits could be modest, compared with the decrease in debt that would come from indexing benefits to inflation. The add-on personal account could be made more generous for lower-income workers as well, by the government matching individual contributions (much as the tax code subsidizes retirement saving by higher-income taxpayers through individual retirement accounts or 401(k)s). Alternatively, the system's progressivity could be enhanced by increasing tax benefits for lower-income workers.

President Bush has started an important conversation by emphasizing personal accounts. It is possible to improve Social Security contributions to economic well-being by introducing personal accounts and decreasing the relative importance of traditional benefits for middle- and upper-income Americans.