National Center for Policy Analysis

BRIEF ANALYSIS
No. 293
For immediate release:
Monday, June 7, 1999

The Language of Social Security Reform

The debate over Social Security reform has evolved significantly over the past few years — and especially the past few months. Almost everyone agrees that Social Security is in financial trouble. Both Republicans and Democrats have been looking for solutions and evaluating reform options, leading to a whole new vocabulary of reform.

The Carve-Out Option. Most reform plans that create personal retirement accounts propose to fund those accounts by using the budget surplus, but the mechanism differs from plan to plan. The most common mechanism is a "carve-out." Under a carve-out, some portion of a worker's 12.4 percent Social Security payroll tax (the remaining 2.9 percent of the payroll tax goes for Medicare) is redirected into a personal retirement account. Funds in these accounts are invested in stocks and bonds, and the accounts are owned by the individual worker.

Social Security Reform Plans

Benefits Replaced:	Funding Private Accounts: Add-On	Funding Private Accounts: Carve-Out
Claw-Back	Archer-Shaw	Phil Gramm Rick Santorum
Drop-Back	Mark Sanford	Kolbe-Stenholm Gregg-Breaux-Kerrey Nick Smith Rod Grams
No Change	Bill Clinton	Moynihan*

* Raises the retirement age and makes other benefit reductions unrelated to investments in private accounts.

For example, under Sen. Phil Gramm's (R-Texas) reform proposal, workers who choose the private-sector option redirect (carve out) 3 percentage points from their payroll taxes into their personal retirement accounts, and the remaining 9.4 percentage points continue to go to the Social Security trust fund. Under this plan, private funding replaces government funding of Social Security benefits as workers' account balances grow over time.

Examples of 2 percent carve-out plans include a proposal by Sens. Judd Gregg (R-N.H.), John Breaux (D-La.) and Bob Kerrey (D-Neb.) and a House version by Reps. Jim Kolbe (R-Ariz.) and Charlie Stenholm (D-Texas). Sen. Rick Santorum (R-Pa.) has proposed a carve-out option that varies the allowed deposit by income level — ranging from 4 percent for low-income workers to 3 percent for high-income workers. A proposal by Sen. Pat Moynihan (D-N.Y.) contains a 2 percent carve-out as a way of reducing the Social Security surplus, but it does not require that the money be saved and invested.

The Add-On Option. As an alternative to carve-outs, add-on proposals fund private retirement accounts in some way other than by diverting the payroll tax.

For example, during his State of the Union address, President Clinton proposed Universal Savings Accounts (USA accounts). Under this proposal, workers automatically receive a tax credit of up to $600 per couple per year, deposited in their USA account. The couple can save up to $700 per year more in the account, and the government will match their savings dollar-for-dollar. With the automatic tax credit of $600 plus the matched tax credit of $700, the family will have $2,000, including the $1,300 tax credit, in retirement savings each year. At retirement, seniors can draw on their USA accounts in addition to drawing Social Security. Thus the president's add-on proposal has no impact on the financial obligations of the existing Social Security system.

An add-on plan that does reduce Social Security's long-term liability has been proposed by House Ways and Means Chairman Bill Archer (R-Texas) and Rep. Clay Shaw (R-Fla.). Their plan creates private retirement accounts, financed by a 2 percent refundable income tax credit.

A controversial feature of the Archer-Shaw plan is that it requires individuals to turn their account balance over to the government at retirement. The government then pays them a monthly annuity. Most other reform plans rely on private markets to pay the annuities funded from private retirement account accumulations.

The Claw-Back Option. All reform proposals that seek to replace the current pay-as-you-go system with a system funded by personal retirement accounts have a mechanism for reducing the government's obligation to pay benefits. One such mechanism is known as a "claw-back."

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Under this approach, each individual's monthly retirement benefit paid by Social Security is reduced by the amount funded from that individual's private account. For example, if the private retirement account is able to fund 60 percent of a retiree's monthly benefit, the government pays the other 40 percent. As private accounts accumulate, Social Security's financial obligation declines. Under the Gramm plan, for example, virtually all workers eventually fund their retirements from their personal retirement accounts.

Some claw-back proposals permit workers who participate in the private system to receive a "bonus" at retirement over and above what they would have gotten under the current Social Security system. This bonus is a percent of their original Social Security benefit. For example, the Gramm plan includes a 20 percent bonus.

A criticism of claw-back plans is that workers gain little from their private investments, since each dollar they save reduces the monthly pension they receive from the government. For example, at the time of retirement each dollar in a retiree's personal retirement account leads to a one dollar reduction in government funding under Archer-Shaw and an 80 cent reduction under Gramm. The same criticism, however, applies to one degree or another to all plans that replace pay-as-you-go Social Security with a funded system. The primary purpose of these proposals is first to achieve retirement security and then, if possible, to increase retirement benefits. Retiree benefits become more secure because they are funded with real assets rather than depending on the willingness of future taxpayers to pay high taxes.

An advantage of claw-back proposals is that they come with a government guarantee that every retiree will receive at least the same benefits as those promised under the current Social Security system. As a result, individuals making private investments face few of the risks that critics constantly warn about. Because of the full integration of benefits and investments, no one can be worse off than under the current system — regardless of what happens in financial markets.

This guarantee means that claw-back proposals must narrow the range of individuals' investment options. Since everyone knows that he or she will get the promised benefits, many will be tempted to make risky investments. For this reason, claw-back proposals limit investment choices to conservative, diversified portfolios.

The Drop-Back Option. As in the case of the claw-back, "drop-back" plans reduce the government's financial obligation as private account balances grow. But with the drop-back plan, a person can benefit from the internal growth of the private account by taking a little more risk.

For example, the Gregg-Breaux-Kerrey plan allows workers to invest their account in one of three index funds — a Treasury bond fund, a stock fund or a corporate bond fund. Under the Senate version, at retirement government-paid benefits are reduced by the amount that could have been funded from private funds had they been invested in Treasury bonds. The House version has a similar provision.

Under Rep. Mark Sanford's (R-S.C.) proposal, each worker's individual account gets an annual share of the Social Security surplus proportional to what he or she has paid in. At retirement, the worker's benefit is reduced by the amount the government has deposited, adjusted for inflation. For example, if total rebates equal 25 percent of the expected Social Security benefit, the retiree's monthly benefit is reduced by 25 percent. Retirees benefit from this scheme as long as their portfolio returns are greater than the rate of inflation.

An advantage of the drop-back option is that individuals have more investment options, and they benefit from wise choices. A criticism is that individuals can do worse than they would have done under the current system if their investments perform poorly. An early analysis of the Kolbe-Stenholm plan concluded that workers who earn a real rate of return higher than 4.5 percent will do better with private accounts than under Social Security. If the return is less than 4.5 percent, they will be worse off. However, the Kolbe-Stenholm plan includes a minimum benefit guarantee for lower-income retirees so most will not be worse off.

Conclusion. Although they differ in approach, all of the reform plans except those of President Clinton and Sen. Moynihan aim to reduce the reliance on the current pay-as-you-go Social Security system while assuring retirement benefits in the future for workers. Without reform in the near future, the pay-as-you-go system cannot sustain the tax rates that will be required to pay benefits to retirees in the mid-21st century.

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