



# Social Security Choice

February 17, 2004 SSP No. 32

## *The 6.2 Percent Solution* *A Plan for Reforming Social Security*

*by Michael Tanner*

### Executive Summary

For the past several years there has been a growing consensus about the need to reform Social Security. Now, however, the debate has advanced to the point where it becomes important to move beyond generalities and provide specific proposals for transforming Social Security to a system of individual accounts. The Cato Project on Social Security Choice, therefore, has developed a proposal to give workers ownership of and control over their retirement funds.

Under this proposal:

- Individuals would be allowed to divert their half (6.2 percentage points) of the payroll tax to individually owned, privately invested accounts. Those who chose to do so would agree to forgo all future accrual of retirement benefits under the traditional Social Security system.
- The remaining 6.2 percentage points of payroll taxes would be used to pay transition costs and to fund disability and survivors' benefits.
- Workers who chose the individual account option would receive a "recognition bond"

based on the accrued value of their lifetime-to-date benefits. Those bonds, redeemable at the worker's retirement, would be fully tradable in secondary markets.

- Those who wished to remain in the traditional Social Security system would be free to do so, accepting a level of benefits payable with the current level of revenue.

We expect this plan to restore Social Security to long-term and sustainable solvency and to do so at a cost that is less than the cost of simply propping up the existing program. And it would do far more than that.

Younger workers who chose the individual account option would receive benefits substantially higher than those that could be paid under traditional Social Security. At the same time, the plan would treat women and minorities more fairly and allow low-income workers to accumulate real wealth.

Most important, this proposal would reduce Americans' reliance on government and give individuals greater ownership of wealth, as well as responsibility for and control over their own lives. It would be a profound and significant increase in individual liberty.

**We expect this proposal to restore Social Security to long-term and sustainable solvency and to do so at a cost less than the cost of simply continuing the existing program.**

## **Introduction**

For the past several years there has been a growing consensus about the need to reform Social Security. As the debate has developed, the Cato Institute has provided studies and other information on the problems facing Social Security and the advantages of individual accounts as a way to reform the system. But until now we have not suggested a specific plan for reform.

Now, however, the debate has advanced to the point where it becomes important to move beyond generalities and provide specific proposals for transforming Social Security to a system of individual accounts. The Cato Project on Social Security Choice, therefore, has developed a proposal to give workers ownership of and control over their retirement funds.

This plan would establish voluntary personal accounts for workers born on or after January 1, 1950. Workers would have the option of (a) depositing their half of the current payroll tax (6.2 percentage points) in an individual account and forgoing future accrual of Social Security retirement benefits or (b) remaining in the traditional Social Security system and receiving the level of retirement benefits payable on a sustainable basis given current revenue and expenditure projections.

Workers choosing the individual account option would have a variety of investment options, with the number of options increasing as the size of their accounts increased. The initial default option would be a balanced fund, weighted 60 percent stocks and 40 percent bonds. Workers choosing the individual account option would also receive bonds recognizing their past contributions to Social Security.

At retirement, workers would be able to choose an annuity, a programmed withdrawal option, or the combination of an annuity and a lump-sum payment. The government would maintain a safety net to insure that no senior would retire with income less than 120 percent of the poverty level.

We expect this proposal to restore Social Security to long-term and sustainable solvency and to do so at a cost less than the cost of simply continuing the existing program. And it would do far more than that.

Workers who chose the individual account option could accumulate retirement resources

substantially greater than those that are currently payable under traditional Social Security. They would own and control those assets. At the same time, women and minorities would be treated fairly, and low-income workers could accumulate real wealth.

Most important, this proposal would reduce Americans' reliance on government and give individuals greater responsibility for and control over their own lives. It would provide a profound and significant increase in individual liberty.

## **The Social Security Crisis**

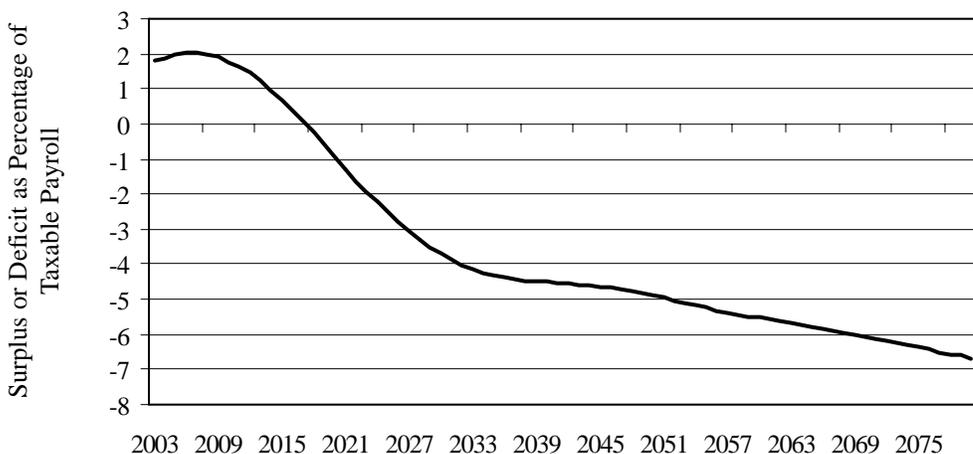
Social Security as we know it is facing irresistible demographic and fiscal pressures that threaten the future retirement benefits of today's young workers. Although Social Security is currently running a surplus, according to the system's own trustees, that surplus will turn into a deficit within the next 15 years.<sup>1</sup> That is, by 2018 Social Security will be paying out more in benefits than it takes in through taxes (Figure 1).

In theory, Social Security is supposed to continue paying benefits after 2018 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide sufficient funds to continue paying full benefits until 2042, after which it will be exhausted. At that point, by law, Social Security benefits will have to be cut by approximately 27 percent.<sup>2</sup>

However, in reality, the Social Security Trust Fund is not an asset that can be used to pay benefits. Any Social Security surpluses accumulated to date have been spent, leaving a trust fund that consists only of government bonds (IOUs) that will eventually have to be repaid by taxpayers. As the Clinton administration's fiscal year 2000 budget explained it:

These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—but only in a bookkeeping sense. . . . *They do not consist of real economic assets that can be drawn down in the future to fund benefits.* Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust

**Figure 1**  
**Social Security's Payroll Tax Surplus or Deficit**



Source: 2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, table IV.B1.

Fund balances, therefore, does not by itself have any impact on the Government's ability to pay benefits.<sup>3</sup>

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2042. At that point, Social Security will have to rely solely on revenue from the payroll tax—but that revenue will not be sufficient to pay all promised benefits. Overall, Social Security faces unfunded liabilities of nearly \$26 trillion.<sup>4</sup> Clearly, Social Security is not sustainable in its current form.

There are few options for dealing with the problem. That opinion is held by people who are not supporters of individual accounts as well as by those who are. As former president Bill Clinton pointed out, the only way to keep Social Security solvent is to (a) raise taxes, (b) cut benefits, or (c) get a higher rate of return through private capital investment.<sup>5</sup> Henry Aaron of the Brookings Institution, a leading opponent of individual accounts, agrees. "Increased funding to raise pension reserves is possible only with some combination of additional tax revenues, reduced benefits, or increased investment returns from investing in higher yield assets," he told Congress in 1999.<sup>6</sup>

The tax increases or benefit cuts would have to be quite large. To maintain benefits in the first year after Social Security starts running a deficit,

the government must acquire revenues equivalent to \$197 per worker. By 2042, the additional tax burden increases to \$1,976 per worker, and by 2078 it reaches an astounding \$4,193 per worker (in constant 2003 dollars).<sup>7</sup> And it continues to rise thereafter. Functionally, that would translate into either a huge increase in the payroll tax, from the current 12.4 percent to as much as 18.9 percent by 2077, or an equivalent increase in income or other taxes.<sup>8</sup>

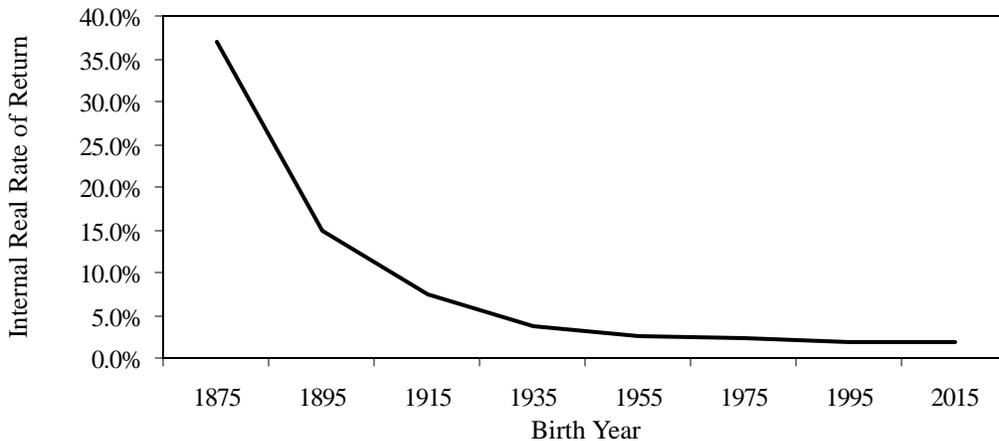
### **A Declining Rate of Return**

Social Security taxes are already so high, relative to benefits, that Social Security has quite simply become a bad deal for younger workers, providing a low, below-market rate of return. As Figure 2 shows, that return has been steadily declining and is expected to be less than 2 percent for most of today's workers.

The poor rate of return means that many young workers' retirement benefits will be far lower than if they were able to invest their payroll taxes privately.<sup>9</sup> On the other hand, a system of individual accounts, based on private capital investment, would provide most workers with significantly higher returns. Those higher returns would translate into higher retirement benefits, leading to a more secure retirement for millions of seniors.

**As Bill Clinton pointed out, the only way to keep Social Security solvent is to raise taxes, cut benefits, or get a higher rate of return through private capital investment.**

**Figure 2**  
**Inflation-Adjusted Internal Real Rate of Return from OASI**



Source: Dean Leimer, "Cohort-Specific Measures of Lifetime Net Social Security Transfers," Social Security Administration, Office of Research and Statistics, Working Paper no. 59, February 1994.

### Savings and Economic Growth

Social Security operates on a pay-as-you-go (PAYGO) basis; almost all of the funds coming in are immediately paid out to current beneficiaries. This system displaces private, fully funded alternatives under which the funds coming in would be saved and invested for the future benefits of today's workers. The result is a large net loss of national savings, which reduces capital investment, wages, national income, and economic growth. Moreover, by increasing the cost of hiring workers, the payroll tax substantially reduces wages, employment, and economic growth.

Shifting to a private system, with hundreds of billions of dollars invested in individual accounts each year, would likely produce a large net increase in national savings, depending on how the government financed the transition. That would increase national investment, productivity, wages, jobs, and economic growth. Replacing the payroll tax with private retirement contributions would also improve economic growth because the required contributions would be lower and would be seen as part of a worker's direct compensation, stimulating more employment and output.

In 1997 Harvard economist Martin Feldstein estimated that, if all Social Security payroll taxes were privately invested, that investment

would produce a net benefit of from \$10 trillion to \$20 trillion in present value.<sup>10</sup> That is his estimate of the present value of the improved economic performance that would result from the reform. Most of that net benefit would probably come in the form of higher returns and benefits earned for retirees through the private investment accounts. But some would also come in the form of higher wages and employment for working people.

### Helping the Poor and Minorities

Low-income workers would be among the biggest winners under a system of privately invested individual accounts. Private investment would pay low-income workers significantly higher benefits than can be paid by Social Security. And that does not take into account the fact that blacks, other minorities, and the poor have below-average life expectancies. As a result, they tend to live fewer years in retirement and collect less in Social Security benefits than do whites. Under a system of individual accounts, by contrast, they would retain control over the funds paid in and could pay themselves higher benefits over their fewer retirement years, or leave more to their children or other heirs.<sup>11</sup>

The higher returns and benefits of a private investment system would be most important to

**If all Social Security payroll taxes were privately invested, that investment would produce a net benefit of from \$10 trillion to \$20 trillion in present value.**

low-income families, as they most need the extra funds. The funds saved in individual retirement accounts, which could be left to the children of the poor, would also greatly help families break out of the cycle of poverty. Similarly, the improved economic growth, higher wages, and increased jobs that would result from an investment-based Social Security system would be most important to the poor. Moreover, without reform, low-income workers will be hurt the most by the higher taxes or reduced benefits that will be necessary if we continue on our current course. Averting a financial crisis and its inevitable results would consequently be most important to low-income workers.

In addition, with average- and low-wage workers accumulating huge sums in their own investment accounts, the distribution of wealth throughout society would become far broader than it is today. That would occur not through the redistribution of existing wealth but through the creation of new wealth, far more equally held. Because a system of individual accounts would turn every worker into a stockowner, the old division between labor and capital would be eroded. Every laborer would become a capitalist.

### Ownership and Control

After all the economic analysis, however, perhaps the single most important reason for transforming Social Security into a system of individual accounts is that it would give American workers true ownership of and control over their retirement benefits.

Many Americans believe that Social Security is an “earned right.” That is, they think that, because they have paid Social Security taxes, they are entitled to receive Social Security benefits. The government encourages this belief by referring to Social Security taxes as “contributions,” as in the Federal Insurance Contributions Act (FICA). However, the U.S. Supreme Court has ruled, in the case of *Flemming v. Nestor*, that workers have no legally binding contractual or property right to their Social Security benefits, and those benefits can be changed, cut, or even taken away at any time.<sup>12</sup>

As the Court stated, “To engraft upon Social Security a concept of ‘accrued property rights’ would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands.”<sup>13</sup> That decision built on a

previous case, *Helvering v. Davis*, in which the Court had ruled that Social Security is not a contributory insurance program, stating that “the proceeds of both the employer and employee taxes are to be paid into the Treasury like any other internal revenue generally, and are not earmarked in any way.”<sup>14</sup>

In effect, Social Security turns older Americans into supplicants, dependent on the political process for their retirement benefits. If they work hard, play by the rules, and pay Social Security taxes their entire working lives, they earn the privilege of going hat in hand to the government and hoping that politicians decide to give them some money for retirement.

In contrast, under a system of individual accounts, workers would have full property rights in their private accounts. They would own their accounts and the money in them the same way they own their individual retirement accounts (IRAs) or 401(k) plans. Their retirement benefits would not depend on the whims of politicians.

## Principles for Reform

In developing a proposal for Social Security reform, we relied on five basic principles:

### Solvency Is Not Enough

The goal of Social Security reform should be to provide workers with the best possible retirement option, not simply to find ways to preserve the current Social Security system. After all, if solvency were the only goal, that could be accomplished with tax increases or benefit cuts, no matter how bad a deal that provided younger workers. A successful Social Security reform will of course result in a solvent system, not just in the short run, but sustainable over time as well. And it will also improve Social Security’s rate of return; provide better retirement benefits; treat women, minorities, and low-income workers more fairly; and give workers real ownership of and control over their retirement funds.

### Don’t Touch Grandma’s Check

Although there is no legal right to Social Security benefits, workers who have relied on the program in good faith should not become

**The goal of Social Security reform should be to provide workers with the best possible retirement option, not simply to find ways to preserve the current Social Security system.**

**Small account proposals will not allow low- and middle-income workers to accumulate real wealth or achieve other objectives of reform.**

scapegoats for the government's failures. Workers who are retired today or who are nearing retirement should not have their benefits reduced or threatened in any way.

### **More Investment Is Better Than Less**

You don't cut out half a cancer. Many proposals for Social Security reform would allow workers to privately invest only a small portion of their payroll taxes; they would continue to rely on the existing PAYGO Social Security system for the majority of Social Security benefits. But small account proposals will not allow low- and middle-income workers to accumulate real wealth or achieve other objectives of reform. Individual accounts should be as large as feasible.

### **Individuals, Not Government, Should Invest**

The only way to increase Social Security's rate of return is to invest in private capital assets. This should be done through the creation of individually owned accounts, not by allowing the government to directly invest Social Security surpluses. Individual accounts would give workers ownership of and control over their retirement funds, allowing them to accumulate wealth and pass that wealth on to their heirs; it would also give them a stake in the American economic system. Government investment would allow the federal government to become the largest shareholder in every American company, posing a potential threat to corporate governance and raising the possibility of social investing. And government, not workers, would still own and control retirement benefits.

### **Be Honest**

The American people can handle an open and honest debate about Social Security reform. Individual accounts will create a better, fairer, and more secure retirement system. But they cannot create miracles. They will provide higher retirement benefits than Social Security can pay. But they will not make everyone a millionaire. They will help solve Social Security's financial crisis and save taxpayers trillions of dollars over the long run. But there is no free

lunch. There are short-term costs that will require the president and Congress to make tough choices.

### **Promised vs. Payable Benefits**

Opponents of individual accounts frequently suggest that the creation of such accounts would result in cuts in the promised level of Social Security benefits. Those critics are confusing changes necessary to restore the system to balance with changes resulting from individual accounts. As noted above, Social Security faces unfunded liabilities of nearly \$26 trillion. Quite simply, unless there is a substantial increase in taxes, the program cannot pay the promised level of benefits.

That is not merely a matter of conjecture; it is a matter of law. The Social Security Administration is legally authorized to issue benefit checks only as long as there are sufficient funds available in the Social Security Trust Fund to pay those benefits. Once those funds are exhausted, in 2042 by current estimates, Social Security benefits will automatically be reduced to a level payable with existing tax revenues, approximately 73 percent of the current benefit levels.<sup>15</sup>

This, then, is the proper baseline to use when discussing Social Security reform. Social Security must be restored to a sustainable level regardless of whether individual accounts are created.

As the Congressional Budget Office puts it:

A number of recent proposals to reform Social Security call for changes in the program's benefits. The effects of those proposals are frequently illustrated by comparing the new benefits to those expected to arise under the policies put in place by current law—showing whether they would be higher or lower and by how much. However, because of scheduled changes in benefit rules, a growing economy, and improvements in life expectancy, the benefits prescribed under current law do not represent a stable baseline. Their value will vary significantly across future age cohorts. Thus, focusing on differences from current law will not fully portray the effects of proposed benefit changes.<sup>16</sup>

It is wrong, therefore, to attribute to individual accounts benefit cuts that would be needed to bring the system into balance irrespective of whether individual accounts are created.

It is clear, in fact, that individual accounts by themselves do not cause any reduction in total retirement benefits (defined as the combination of account accumulations and traditional Social Security benefits). The best illustration of this concept is the first of three plans proposed by the President's Commission to Strengthen Social Security. That plan would create individual accounts (2 percent of payroll is used for illustrative purposes) but make no other changes to bring Social Security into solvency. The result is that Social Security remains insolvent (although the plan does improve financing by 8 percent), but the combined benefit received by workers is higher than benefits currently promised by Social Security.<sup>17</sup>

Because one goal of this reform plan is to bring the Social Security system into balance and eliminate the system's unfunded liabilities, changes are made to bring the system's finances into balance in a sustainable PAYGO system. Those changes are separate from the creation of individual accounts.

Therefore, in comparing benefit levels, payable benefits is the appropriate baseline.

## **A Proposal for Individual Accounts**

Current workers should be given a choice. Beginning January 1, 2005, workers born on or after January 1, 1950, would have two options: Those who wish to remain in the traditional Social Security system would be free to do so, accepting a level of benefits payable with existing levels of revenue. Those workers would continue to pay the full 12.4 percent payroll tax and would continue to receive Social Security benefits as under current law. However, beginning in 2012, the formula used to calculate the accrual of benefits would be adjusted to index them to price inflation rather than national wage growth.<sup>18</sup>

That change would have no impact on people who are already retired, since benefits after retirement are already adjusted according to inflation (that's what cost-of-living adjustments, or COLAs, are). Nor would it reduce

benefits for those nearing retirement. However, for younger workers, benefits would gradually be adjusted to a level sustainable under the current level of payroll taxation.

At the same time, those workers who wished to enter the new market-based system would be allowed to divert their half of the payroll tax (6.2 percentage points) to individually owned, privately invested accounts.<sup>19</sup> Those choosing to do so would agree to forgo all future accrual of retirement benefits under traditional Social Security. The remaining 6.2 percentage points of payroll taxes would be used to pay transition costs and to fund disability and survivors' benefits. Once transition costs were fully paid, this portion of the payroll tax would be reduced to the level necessary to pay survivors' and disability benefits.

Although they would forgo future benefits under traditional Social Security, workers who chose the individual account option would receive a bond in recognition of their past contributions to Social Security. That bond would be a zero-coupon bond calculated to provide a benefit based on accrued benefits under the current Social Security system as of the date that the individual chose an individual account.<sup>20</sup> The bonds would be fully tradable on secondary markets, but all proceeds would have to be fully redeposited in the worker's individual account until the worker became eligible to make withdrawals.

The recognition bonds may be valued at something less than the full present value of accrued benefits because we believe that workers will attach a value to receiving a tangible asset, making them willing to accept a discount in the face value of the bond. Indeed, polls show that a third of younger workers would opt out of Social Security even if they didn't get back a cent of the payroll taxes they've put in.<sup>21</sup> In addition, because the recognition bonds would be tradable, workers who wished to do so could sell them and allocate the sale price among higher-earning assets in the same way they do other contributions (see below). Finally, because the accrued benefits are calculated against current law, for some younger workers the level of those benefits would be higher than the level of benefits that would be payable under a sustainable PAYGO system. Those workers, therefore, receive something of a windfall through recognition bonds.

**Workers would be allowed to divert their half of the payroll tax (6.2 percentage points) to individually owned, privately invested accounts.**

**The system should adopt a “hold harmless point,” such that once an individual can purchase an annuity equal to 120 percent of the poverty level, he or she can opt out of the system altogether and stop paying the 6.2 percent individual account contribution.**

Workers would also have the option of depositing up to an additional 10 percent of their earnings in their accounts on a voluntary basis (that is, over and above the 6.2 percent payroll tax or contribution). Voluntary additional contributions would be made on an after-tax basis, and their investment, buildup, and distribution would be treated identically to the 6.2 percent account contribution discussed above.

Funds deposited in individual accounts would be invested in real capital assets under a three-tiered system.

#### **Tier I**

Collection of payroll taxes, including individual account contributions, continues to be handled by the employer in much the same way as today. A worker’s employer sends payroll taxes to the U.S. Treasury. The employer tells Treasury how much of the total payment is from employees who have chosen the personal retirement account option. Treasury then transfers that portion to a private-sector custodian bank, which invests the total amount in a money market fund that is always priced at one dollar, a standard industry convention. The following year, when the contribution is reconciled to the individual’s name using the W-2 form, the fund’s shares representing his contributions and interest credit are distributed to each worker and electronically transferred to the default account as specified under Tier II.

#### **Tier II**

Workers initially have a choice of three investment options. As soon as a worker’s contributions are reconciled, they are electronically deposited in one of three balanced funds, each highly diversified and invested in thousands of securities. The default portfolio, where one’s money is invested if no choice is made, has 60 percent stocks and 40 percent bonds. The two other funds have the same asset classes but with different weights. For younger workers one fund with a higher concentration of stocks is created, and another, more geared toward less-volatile bonds, is created for those near retirement. Workers can move their funds from the default portfolio to either of the other two options.

#### **Tier III**

Once a worker has accumulated some “trigger” level of funds, the worker is free to participate in a much larger range of investment options, closely approximating the options currently available under traditional 401(k) plans.<sup>22</sup>

The institutions and providers managing funds under Tier III may choose to offer additional goods and services, such as retirement planning software, to attract assets from Tier II. Each worker can allocate his assets at will among Tier III providers. This ensures stiff competition as each provider strives to meet investors’ needs. Costs would most likely be greater than in Tier II, but they would be incurred only if an individual chose to shift to Tier III.<sup>23</sup>

At retirement workers are able to choose an annuity, a programmed withdrawal option, or the combination of an annuity and a lump-sum payment. They can choose to annuitize their entire account holdings, or they can choose programmed withdrawals from the principal of their account, based on twice their life expectancy. If they choose the latter option, funds in their accounts will remain invested under the same provisions as before retirement. If a worker choosing the programmed withdrawal option dies before his assets are exhausted, those assets become part of his estate and are fully inheritable in the same way as any other asset. Finally, workers can choose to purchase an annuity providing annual income equal to 120 percent of the poverty level and take any funds available above this level as a lump sum.

Further, we believe that the system should adopt a “hold harmless point,” such that once an individual can purchase an annuity equal to 120 percent of the poverty level, he or she can opt out of the system altogether and stop paying the 6.2 percent individual account contribution. For married couples, the hold harmless point would occur when the couple had accumulated sufficient combined funds to purchase a family annuity equal to 240 percent of the single-adult poverty threshold.

Contributions to individual accounts are on a posttax basis. Interest, dividends, and capital gains accruals on investments within individual accounts, and all eligible withdrawals from the accounts, are exempt from income taxes. In most ways, individual Social Security accounts resemble Roth IRAs.<sup>24</sup>

Finally, the federal government provides a safety net insuring that no worker's retirement income falls below 120 percent of the poverty level. Workers whose accumulations under the private investment option fall below the amount required to purchase an annuity at that level receive a supplement sufficient to enable them to purchase such an annuity.<sup>25</sup> This safety net is funded from general revenues rather than from the Social Security payroll tax.

Some proposals for Social Security reform provide much higher benefit guarantees; some guarantee that no one will ever receive less than payable or even promised Social Security benefits. Aside from the obvious expense of such guarantees, this approach is flawed in two respects. First, it seems wrong to make taxpayers responsible for guaranteeing investments by high-income workers who do not depend on Social Security for their retirement income. Should a factory worker really be on the hook to guarantee Bill Gates's investment choices? Second, guarantees inevitably create a "moral hazard" issue. Workers would be encouraged to speculate and make risky investment choices, knowing that they would reap the potentially higher gains from such investments and be protected from any possible losses. This is very similar to the type of moral hazard that led to the savings-and-loan crisis of the 1980s.<sup>26</sup>

Finally, although the individual account option is completely voluntary for current workers, it will eventually become mandatory for those workers who have not yet entered the labor force. As a result, the PAYGO Social Security system will eventually be replaced entirely by a market-based one.

## **Paying for the Transition**

Although moving to a system of individual accounts will save money in the long run, there will almost certainly be a short-term requirement for additional revenues.<sup>27</sup> That is because, to the degree that workers choose the individual account option, payroll tax revenues are redirected from the payment of current benefits to personal accounts. But because most of the workers who choose accounts are likely to be young, it will be many years before the accounts result in significant savings to the traditional system.

Where, then, will the transitional financing come from? Ultimately, this is a decision for Congress, which will have to weigh the utility of various financing mechanisms, including debt, taxes, and reductions in current government spending.

However, three sources are worth special note. First, the portion of taxes on Social Security benefits currently used to fund Medicare should be redirected back to Social Security. That would provide an estimated \$8.3 billion annually in additional revenue.<sup>28</sup>

Second, the Cato Institute has identified more than \$87 billion annually in corporate welfare, roughly defined as "any government spending program that provides payments or unique benefits and advantages for specific companies or industries."<sup>29</sup>

Sen. John McCain (R-AZ) and Rep. Richard Gephardt (D-MO) have called for a commission to pinpoint and eliminate corporate subsidies. Congress should take this idea a step further and earmark the savings for individual accounts. Senator Graham has proposed such a commission as part of Social Security reform legislation that he has introduced.<sup>30</sup>

Third, to the degree that they actually represent an increase in national savings, contributions to individual accounts may, in themselves, prove to be a source of additional revenue for the federal government, revenue that could be used to help finance the transition.

It works in this way: The return on investment received by individuals is not the actual return earned by a given investment. A portion of the returns is actually taxed away through corporate taxes before returns are realized at the level of the individual investor. Therefore, a portion of the funds diverted to individual accounts is actually "recaptured" and available to help fund the transition.<sup>31</sup> The Social Security Administration estimates that this revenue recapture would provide "a substantial and growing source of income to the OASDI program."<sup>32</sup>

In a 1999 memo to Sen. Phil Gramm, the Social Security Administration estimated that, to the degree that contributions to individual accounts represent a net increase in savings, the recapture would be equal to 31.4 percent of the real, before-tax return on investments. This is based on an assumed average corporate tax rate of 35 percent applied against an assumed net

**Should a factory worker really be on the hook to guarantee Bill Gates's investment choices?**

**Financing the transition is a one-time event that actually serves to reduce the government's future liabilities.**

new savings of 68.4 percent of assets invested through individual accounts.<sup>33</sup>

After using the three financing sources discussed above, we believe that any remaining transition could be financed through reductions in other wasteful government spending.<sup>34</sup> Simply restraining the projected growth in non-defense discretionary spending by 1 percent would generate more than \$20 billion per year.<sup>35</sup>

We recognize that it may be necessary to issue some new debt to cover short-term year-to-year cash shortfalls. If that should become necessary, we believe that the issuance of such debt should be honest, explicit, and on budget. At the same time, we should understand that this would not really be new debt; it would simply be making explicit an already existing implicit debt.

It is also important to remember that the financing of the transition is a one-time event that actually serves to reduce the government's future liabilities. The transition moves the government's need for additional revenue forward in time, but—depending on the transition's ultimate design—it does not necessarily increase the amount of spending necessary. In fact, it will likely reduce the total cost of Social Security. In effect, it is a case of pay a little now or pay a lot later.

### **Why 6.2 Percent Accounts?**

Some proposals for creating individual accounts as part of Social Security reform keep most of the traditional PAYGO Social Security structure in place and offer only very small accounts, allowing workers to privately invest just 2–3 percentage points of payroll taxes.

People who support plans with small individual accounts generally do so for one of three reasons:

- A political calculation that small accounts will avoid charges of “privatizing” Social Security;
- A desire to diversify risk by splitting responsibility for retirement income between markets and government, combining defined-contribution and defined-benefit programs; or
- Concern over short-term annual cash deficits.

However, given the clear advantages of larger accounts, none of those reasons holds up.

First, small account size seems unlikely to protect supporters from political attack. The recent Medicare reform debate provides a useful example. Despite rollbacks of attempts to introduce market competition to Medicare (the final bill contained only a handful of “demonstration projects” that don’t begin until 2010), the bill was still attacked as an attempt to “privatize” Medicare. Opponents of individual ownership can be expected to be just as vociferous in their denunciations of 2 percent accounts as they would be in attacking 6.2 percent accounts.

At the same time, small account proposals may prove politically counterproductive by dissipating the enthusiasm of grassroots activists and others who support reform and failing to engage the attention of young workers. Opponents of individual accounts are entrenched and well organized. Washington politicians are fearful and reluctant to take on an issue of this magnitude. It will take strong public support to make reform happen.

Generating a sufficient level of support, particularly among generally apathetic younger voters, will require a reform proposal that makes clear how much those voters have to gain from reform. Bold colors, not pale pastels, will be needed to generate that kind of support.

The advantages of larger individual accounts are not lost on voters. A poll conducted by Zogby International for the Cato Institute asked voters how much of their Social Security taxes they wished to invest. A plurality of voters (27.9 percent) chose the full 12.4 percent. Only a slightly smaller group (26.5 percent) chose 6.2 percentage points, as provided for in this proposal. Only 11 percent of voters preferred 2–3 percent accounts. Support for large accounts was consistent across all political, ideological, and demographic groups, with younger voters showing particular support for bigger accounts<sup>36</sup> (Table 1).

Second, although risk diversification is generally a good thing, continued reliance on a government-provided benefit may actually increase the overall risk to workers. Those making this argument generally attach the most risk to the market-based component of a reformed Social Security system (individual accounts) and less or even no risk to the portion provided by government. In reality, however, this misreads both market and political risks.

**Table 1**  
**Portion of Taxes to Be Invested**

	Political Preference				Age			
	Overall	Democrat	Republican	Independent	18–29	30–49	50–64	65+
6.2%	26.5	26.7	21.7	32.5	41.3	29.9	29.2	11.5
2% or 3%	11.0	13.6	9.0	9.6	11.9	12.9	8.8	10.3
12.4%	27.9	22.0	36.2	25.9	32.6	40.2	27.5	11.8
None	20.4	23.2	17.4	20.4	8.4	11.2	22.3	35.4
Not sure	14.2	14.6	15.7	11.6	5.8	5.7	12.1	31.0

Given the long-term investment horizon envisioned for workers choosing individual accounts under this proposal, market investment is remarkably safe. In fact, over the worst 20-year period of market performance in U.S. history, which included the Great Depression, the stock market produced a positive real return of more than 3 percent. At the same time, we know that, even under the best of conditions, Social Security will provide below-market returns. As Figure 3 shows, even with recent stock market declines, a worker investing all of his payroll taxes in stocks would receive benefits 2.8 times greater than he would receive had he “invested” the same amount of money in Social Security.<sup>37</sup>

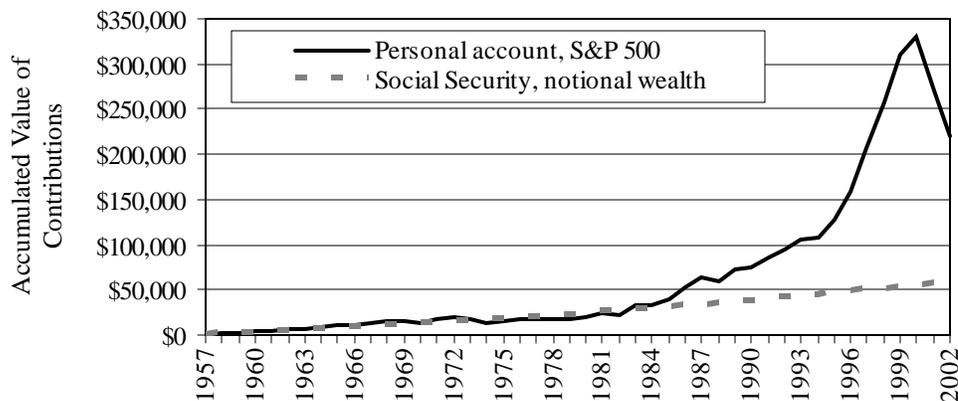
Mixing private investments with traditional Social Security is therefore mixing a good investment (private accounts) with a bad investment (Social Security). That’s not diversification, it’s just bad investment policy.

Moreover, given the lack of property or other legal rights to Social Security benefits, and the program’s enormous unfunded liabilities, traditional Social Security has political risks over and above its poor rate of return.

Besides, the proposed individual account plan provides an opportunity to diversify risk. The proposed default portfolio consists of both stocks and bonds. Risk-averse investors can opt for a portfolio even more heavily weighted toward bonds.

**Traditional Social Security has political risks over and above its poor rate of return.**

**Figure 3**  
**Even after Market Drops, Personal Accounts Would Pay Higher Returns Than the Traditional System**



Source: Andrew Biggs, “Personal Accounts in a Down Market: How Recent Stock Market Declines Affect the Social Security Debate,” Cato Institute Briefing Paper no. 74, September 10, 2002.

**Focusing only on short-term cash flows may be penny-wise and pound-foolish. If system finances were the only issue, we could simply raise taxes or cut benefits.**

Finally, the truly risk averse can avoid private investment altogether. They can choose to remain entirely within the current Social Security system.

People concerned with short-term annual cash flows acknowledge that large accounts would save money in the long run, but they are equally concerned with maintaining the program's financial balance on an annual basis. This concern is due in part to the size of projected annual budget deficits and in part to skepticism about the ability of the federal government to use money saved in the future to repay debt incurred during the transition, rather than for tax cuts or new spending programs. In all honesty, Congress's recent spending habits give some cause for concern.

However, focusing only on short-term cash flows may be penny-wise and pound-foolish. It is much like paying only the minimum payment on a credit card, neglecting the opportunity to pay off the long-term debt altogether. Large account plans do incur greater short-term costs, but they also result in greater long-term savings.

More important, Social Security reform is about more than finances. Indeed, if system finances were the only issue, we could simply raise taxes or cut benefits. True Social Security reform must also provide increased rates of return and higher benefits; correct the inequities of the current system so as to treat working-women, African Americans, and others more fairly; and give low-income workers a greater opportunity to own and accumulate real wealth. By those measures, large accounts do a far better job of achieving true reform.

For example, increasing attention is being paid to the benefits of individual accounts as a way to give low-income workers an opportunity to build wealth. Although any increase in wealth should be encouraged, we should also be honest enough to admit that for low-wage workers 2 percent of their wages is not enough to allow for the accumulation of a real nest egg. Given that their Social Security accounts may often be the only form of savings that low-income workers have, the more we enable them to save, the better.

Finally, small accounts do little to advance the fundamental goals of reducing reliance on government and giving individuals greater responsibility for and control over their lives.

Of course, one might ask, if big accounts are better than small, then why not allow workers to privately invest the full 12.4 percent payroll tax, or at least the roughly 10 percentage points used for OASI benefits?

Although there is no doubt that even bigger accounts would provide higher benefits than those envisioned under our plan, accounts of 10 percent or more may actually result in too much forced savings for many workers.

Most high- and middle-income individuals do not rely solely on Social Security for their retirement income. In fact, the wealthiest fifth of retirees receives only 20 percent of its income from Social Security.<sup>38</sup> Those workers have other (non-Social Security) forms of saving and investment, including IRAs, 401(k) plans, and even individual equity ownership and other investments. Indeed, we can assume that many of those workers have already achieved the level of retirement savings that they desire. Forcing them to save more through Social Security accounts may simply result in their saving less through their other investments. Moreover, in most cases, the non-Social Security investments take place in a less regulated and less constrained environment than that envisioned for individual accounts under Social Security. The end result of excessively large accounts, therefore, might actually be a perverse decrease in the freedom to invest.

Finally, some people have suggested progressive accounts, with low-income workers able to invest a higher proportion of their payroll taxes than those with higher incomes.<sup>39</sup> Such an approach has a great deal of appeal. It would maximize the benefits of individual accounts to low-income workers while holding down overall transition costs and avoiding the problems of oversaving by higher-income workers.

However, there are serious practical and implementation problems with such an approach. In particular, proposals for progressive accounts would appear to shift compliance and administrative costs to employers. The additional record keeping could become a significant burden, particularly for small businesses.

Consider, for example, a worker who holds two jobs. During the day, he works at a well-paid manufacturing job. At night, he supplements his income as a minimum wage bartender. How would his two employers reconcile

his total income to determine the amount that he is able to contribute to his individual account?

One last point: we believe that 6.2 percent accounts are a very easy concept to explain to the average worker. The worker can privately invest his half of the 12.4 percent payroll tax, while the employer's half is used to finance the transition (and fund survivors' and disability benefits). Of course we recognize that, from an economic point of view, there is no difference between the employer and the employee share of the tax. The employee ultimately bears the full cost, but most workers make the distinction in their own minds. A 6.2 percent account proposal, then, becomes clear, concise, and easy to understand in an age of eight-second sound bites.

## Conclusion

More and more Americans agree on the importance of allowing younger workers an opportunity to privately invest their Social Security taxes, but advocates of individual accounts are divided over how large those accounts should be. Some proposals that call for large accounts have very large transition costs, which makes their political viability suspect. Other proposals are relatively less expensive but give workers control over and ownership of only a small portion of their retirement funds. We believe that it is possible both to have large accounts and to be fiscally responsible. This proposal is designed to meet that goal.

The proposed Social Security reform would restore Social Security to long-term and sustainable solvency and would do so at a cost less than that of simply propping up the existing program. It would also do far more than that.

Younger workers who chose the individual account option could receive retirement resources substantially higher than under traditional Social Security. At the same time, women and minorities would be treated more fairly, and low-income workers would be able to accumulate real wealth.

Most important of all, this is a proposal that would give workers ownership of and control over their retirement income. It is a plan that puts people, not government, first. It is a plan that is fiscally responsible and protects future generations of workers and taxpayers.

## Notes

1. *2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds*, <ftp://ftp.ssa.gov/pub/OACT/TR/TR03/tr03.pdf>. Cited hereafter as *2003 Trustees' Report*.
2. *Ibid.*
3. Executive Office of the President of the United States, *Budget of the United States Government, Fiscal Year 2000, Analytic Perspectives*, p. 337. Emphasis added.
4. *2003 Trustees' Report*.
5. William Jefferson Clinton, Speech to the Great Social Security Debate, Albuquerque, NM, July 27, 1998.
6. Henry Aaron, Testimony before the Senate Committee on Finance, 106th Cong., 1st sess., January 19, 1999.
7. Author's calculations, derived from *2003 Trustees' Report*.
8. *Ibid.*, p. 16.
9. See Michael Tanner, "The Better Deal: Estimating Rates of Return under a System of Individual Accounts," Cato Institute Social Security Paper no. 31, October 28, 2003.
10. Martin Feldstein, "Privatizing Social Security: The \$10 Trillion Opportunity," Cato Institute Social Security Paper no. 7, January 31, 1997.
11. See Michael Tanner, "Disparate Impact: Social Security and African Americans," Cato Institute Briefing Paper no. 61, February 5, 2001.
12. *Flemming v. Nestor*, 363 U.S. 603 (1960). For a fuller discussion of this issue, see Charles Rounds, "Property Rights: The Hidden Issue of Social Security Reform," Cato Institute Social Security Paper no. 19, April 19, 2003.
13. *Flemming v. Nestor* at 616.
14. *Helvering v. Davis*, 301 U.S. 619 (1937), quoted in *Flemming v. Nestor* at 616.
15. In practice, rather than reduce each check sent to beneficiaries, the Social Security Administration would stop sending out checks altogether until it accumulated sufficient funds to pay "full" benefits. When those funds were exhausted, checks would again be withheld until sufficient funds accumulated, leading to checks starting and stopping several times over the course of a year. The net effect would

be that total annual benefits would be reduced by the same amount as if each month's benefits had been proportionally reduced.

16. David Koitz, "Measuring Changes to Social Security Benefits," CBO Long-Range Fiscal Policy Brief no. 11, December 1, 2003.

17. The President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans* (Washington: Government Printing Office, December 2001). For an analysis, see Andrew Biggs, "Perspectives on the President's Commission to Strengthen Social Security," Cato Institute Social Security Paper no. 27, August 22, 2002.

18. This is by no means the only method of reducing promised Social Security benefits to a level actually payable under a sustainable PAYGO system. There is a fairly lengthy menu of such proposals, including means testing, adjusting the retirement age, adding an additional bend point to the formula for determining benefits, and changing spousal benefits. See Michael Tanner, "No Second Best: The Unappetizing Alternatives to Individual Accounts," Cato Institute Social Security Paper no. 24, January 29, 2002. However, we believe that changing from wage to price indexing is one of the fairest ways to restore Social Security to PAYGO solvency. For a more in-depth discussion of the benefits of price indexing, see Matthew Miller, *The 2% Solution: Fixing America's Problems in Ways Liberals and Conservatives Can Love* (New York: Public Affairs, 2003), pp. 198–207. In addition, it would be possible to offer workers the choice of receiving the full level of *promised* benefits but requiring them to pay the level of payroll taxes necessary to support those benefits. Such a mechanism has been included in legislation proposed by Sen. Lindsey Graham (R-SC). See the Social Security Solvency and Modernization Act of 2003.

19. Technically workers currently contribute 5.3 percent toward Old-Age and Survivors Insurance (OASI) and 0.9 percent to Disability Insurance (DI). Under our proposal, the employer would assume responsibility for the entire DI contribution (1.8 percent) and would continue to pay 4.4 percent of capped payroll toward the OASI portion of Social Security.

20. The face value of recognition bonds would be calculated by applying the existing Social Security benefit formula (AIME/PIA) to the worker's past covered earnings. The actuarial present value of this accrued-to-date benefit would then be calculated using a discount rate equal to the long-term opportunity cost to government of capital (essentially the 30-year bond rate), or roughly 3.5 percent, and current age- and gender-specific expected mortality rates.

21. Polling conducted by Rasmussen Research Corporation, July 1999.

22. The advisory committee was not able to reach a consensus on what level should constitute the trigger for permitting movement from Tier II investments to Tier III. Several members favored a dollar amount, such as accumulations of at least \$5,000. Others preferred a time-based trigger, for example three years. Still others suggested an accumulation equal to 120 percent of the poverty level. Any of those options would ultimately be acceptable.

23. Workers could also move some or all of their Tier III assets back to Tier II, a platform with fewer features but lower costs. The competition among Tier III providers, and between Tiers II and III, would ensure that workers received the greatest amount of goods and services at the lowest possible cost. For more information on how this three-tiered structure of investments would work, see William Shipman, "How Individual Social Security Accounts Would Work," *Investor's Business Daily*, December 1, 2003.

24. Counterintuitively, saving on a posttax basis, with accumulation and payout tax-free, benefits middle- and low-income individuals more than proposals that would make contributions tax-free but payouts taxable. For further discussion, see Jagadeesh Gokhale and Laurence Kotlikoff, "Who Gets Paid to Save?" *Tax Policy and the Economy* 17 (2003): 112–39.

25. The determination of eligibility for this safety net will take place at the normal retirement age, 67 for most workers covered under our plan, with workers at that age receiving the full subsidy, although payment would not take place until the worker annuitized his account. Workers choosing early retirement would have the amount of their subsidy reduced in much the same way as workers choosing early retirement have their current Social Security benefits reduced.

For married couples, the determination of the federal guarantee would take place at the time that the older spouse reached retirement age. The government would take into consideration the combined accrued assets in both accounts and provide sufficient additional funds to purchase both spouses an individual annuity equal to 120 percent of the poverty level for a single adult.

26. See Andrew Biggs, "The Archer-Shaw Social Security Plan: Laying the Groundwork for Another S&L Crisis," Cato Institute Briefing Paper no. 55, February 16, 2000.

27. The Cato Institute is currently preparing detailed cost projections for this proposal. Those results will be presented in a forthcoming paper.

28. *2003 Annual Report of the Board of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds* (Washington: Government Printing Office, 2003), table 1.C.1, p. 3. In overall budgetary terms, of course, this does not produce a net gain, since it would ultimately increase Medicare shortfalls. But it seems fair to use Social Security funds for Social Security. Medicare will ultimately require its own reform to remain solvent, but that is an issue for another day.

29. Stephen Slivinski, "The Corporate Welfare Budget: Bigger Than Ever," *Cato Institute Policy Analysis* no. 415, October 10, 2001, p. 6.

30. *The Social Security Solvency and Modernization Act of 2003*.

31. For a full discussion of "revenue recapture," see Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998), pp. 62-64, 180-81.

32. Stephen C. Goss, chief actuary, Social Security Administration, Memorandum to Sen. Phil Gramm, April 16, 1999.

33. *Ibid.* SSA also uses this method in calculating revenue feedback under a Social Security reform proposal offered by Peter Ferrara. Stephen C. Goss, Memorandum to Peter Ferrara, December 1, 2003.

34. See, for example, Andrew Taylor, "House

Panels Identify 'Waste, Fraud and Abuse,' But Are Unlikely to End Them," *CQ-Today*, October 2, 2003.

35. See Peter Ferrara, "To Get Spending under Control," *Washington Times*, January 6, 2004. Ferrara notes that such spending restraint would still result in a government 59 percent larger than it is today.

36. The survey of 1,204 likely voters was conducted in July 1999 and has a margin of error of +/- 3.0 percent. <http://www.socialsecurity.org/zogby/fullreport.pdf>.

37. Andrew Biggs, "Personal Accounts in a Down Market: How Recent Stock Market Declines Affect the Social Security Debate," *Cato Institute Briefing Paper* no. 74, September 10, 2002.

38. Neil Gilbert and Neung-Hoo Park, "Privatization, Provision, and Targeting: Trends and Policy Implications for Social Security in the United States," *International Social Security Review* 49 (January 1996): 22.

39. See, for example, Peter Ferrara, "A Progressive Proposal for Social Security Accounts," *Institute for Policy Innovation Policy Report* no. 176, June 2003. Progressive accounts are also a feature of the Social Security Solvency and Modernization Act, sponsored by Sen. Lindsey Graham, and of the President's Commission to Strengthen Social Security's Model 2.

**OTHER SOCIAL SECURITY PAPERS  
AVAILABLE FROM THE CATO INSTITUTE**

31. **The Better Deal: Estimating Rates of Return under a System of Individual Accounts** by Michael Tanner (October 28, 2003)
30. **Large Accounts and Small Cash Deficits: Increasing Personal Account Size within a Fiscally Responsible Social Security Reform Framework** by Andrew G. Biggs (April 25, 2003)
29. **Public Opinion and Private Accounts: Measuring Risk and Confidence in Rethinking Social Security** by John Zogby, Regina Bonacci, John Bruce, Will Daley, and Rebecca Wittman (January 6, 2003)
28. **Retirement Finance Reform Issues Facing the European Union** by William G. Shipman (January 2, 2003)
27. **Perspectives on the President's Commission to Strengthen Social Security** by Andrew G. Biggs (August 22, 2002)
26. **The Trust Fund, the Surplus, and the Real Social Security Problem** by June O'Neill (April 9, 2002)
25. **A Proposed Legal, Regulatory, and Operational Structure for an Investment-Based Social Security System** by Karl J. Borden and Charles E. Rounds Jr. (February 19, 2002)
24. **No Second Best: The Unappetizing Alternatives to Social Security Privatization** by Michael Tanner (January 29, 2002)
23. **The Impact of Social Security Reform on Low-Income Workers** by Jagadeesh Gokhale (December 6, 2001)
22. **Reenginerring Social Security in the New Economy** by Thomas F. Siems (January 23, 2001)
21. **Social Security: Is It "A Crisis That Doesn't Exist"?** by Andrew G. Biggs (October 5, 2000)
20. **"Saving" Social Security Is Not Enough** by Michael Tanner (May 25, 2000)
19. **Property Rights: The Hidden Issue of Social Security Reform** by Charles E. Rounds Jr. (April 19, 2000)