DOMESTIC POLICY

23. Social Security

Congress should allow young workers to redirect the retirement portion of their payroll taxes to individual accounts that can be invested in private capital markets.

Social Security is going broke. The federal government's largest spending program, accounting for nearly 22 percent of all federal spending, faces irresistible demographic and fiscal pressures that threaten the future retirement security of today's young workers. Only by moving to a system of privately invested, individually owned accounts can a system of secure retirement be preserved.

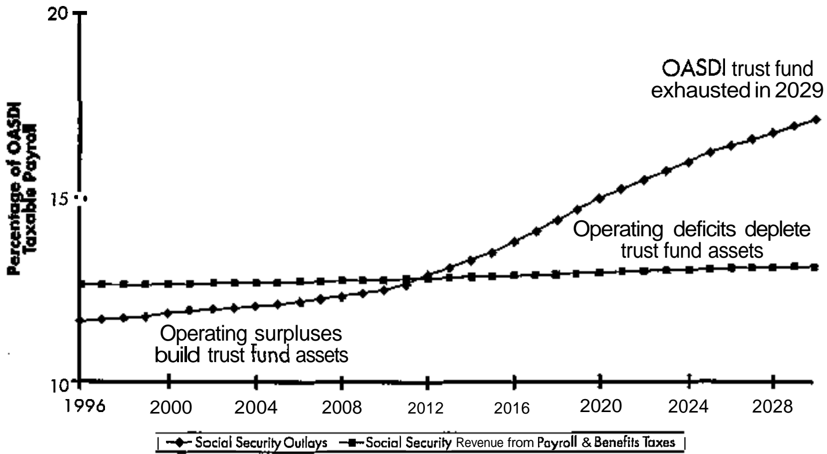
According to the 1996 report of the Social Security system's Board of Trustees, the retirement system will be insolvent by 2029, down from 2030 in last year's report. This is the eighth time in the last 10 years that the insolvency date has been brought forward.

But focusing exclusively on that date is misleading. The implication is that Social Security's financing is fine until 2029, at which point benefits will suddenly stop. The reality is more complex and much more immediately dangerous.

Currently, Social Security taxes bring in more revenue than the system pays out in benefits. The surplus theoretically accumulates in the Social Security Trust Fund. As Figure 23.1 shows, the situation will reverse as early as 2012. Social Security will begin paying out more in benefits than it collects in revenues.

To continue meeting its obligations, the Social Security system will have to begin drawing on the surplus in the trust fund. However, at that point we will discover that the trust fund is really little more than a polite fiction. For years the federal government has used it to disguise the actual size of the federal budget deficit, borrowing money from the trust fund

Figure 23.1
Social Security Revenues versus Outlays



SOURCE: Derived from *1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds* (Washington, D.C.: Social Security Administration, 1996), Table II.F13, p. 108.

to pay current operating expenses and replacing the money with government bonds.

Beginning in 2012, Social Security will have to start turning in those bonds to the federal government to obtain the cash needed to finance benefits. But the federal government has no cash or other assets with which to pay off those bonds. It can obtain the cash only by borrowing and running a bigger deficit, increasing taxes, or cutting other government spending. All those options pose obvious problems.

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2029. At that point, Social Security will have to rely solely on revenue from the payroll tax. But such revenues will not be sufficient to pay all promised benefits. Either payroll taxes will have to be increased to as much as 28 percent, more than double today's 12.4 percent rate, or benefits will have to be reduced by as much as one-third. (If taxes needed to fund Medicare are included, the total FICA payroll tax may have to be increased from today's 15.3 percent to as much as 40 percent!)

Social Security's financing problems are a result of its fundamentally flawed design, which is comparable to the type of pyramid scheme that is illegal in all 50 states. Today's benefits to the old are paid by today's

taxes from the young. Tomorrow's benefits to today's young are to be paid by tomorrow's taxes on tomorrow's young.

Because the average recipient takes out more from the system than he or she paid in, Social Security works as long as there is an ever-larger pool of workers paying into the system compared to the pool of beneficiaries taking out of the system. However, exactly the opposite is happening.

Life expectancy is increasing, while birth rates are declining. As recently as 1950 there were 16 workers for every Social Security beneficiary. Today there are only 3.3. By 2025 there will be fewer than 2 (Figure 23.2). The Social Security pyramid is unsustainable.

Moreover, even if Social Security's financial difficulties can be fixed, the system remains a bad deal for most Americans, a situation that is growing worse for today's young workers. Payroll taxes are already so high that even if today's young workers receive the promised benefits, those benefits will amount to a low, below-market return on payroll taxes. Studies show that for most young workers such benefits would amount to a negative return on the required taxes. Those workers can now get far

Figure 23.2
Support/Benefit Ratio: Workers per Social Security Beneficiary

SOURCE: *1995 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington: Government Printing Office, 1995), page 122.

higher returns and benefits through private savings, investment, and insurance.

Privatizing Social Security

There is a better alternative. Social Security should be privatized, allowing people the freedom to invest their Social Security taxes in financial assets such as stocks and bonds. A privatized Social Security system would essentially be a mandatory savings program. The 10.52 percent payroll tax that is the combined employer-employee contribution to the Old-Age and Survivors Insurance portion of the Social Security program would be redirected toward a personal security account (PSA) chosen by the individual employee.

PSAs would operate much like current individual retirement accounts (IRAs). Individuals could not withdraw funds from their PSAs before retirement, determined either by age or PSA balance requirements. PSA funds would be the property of the individual, and upon death, remaining funds would become part of the individual's estate.

PSAs would be managed by the private investment industry in the same way as 401(k) plans or IRAs. Individuals would be free to choose the fund manager that best met their individual needs and could change managers whenever they wished. The government would establish regulations on portfolio risk to prevent speculation and protect consumers. Reinsurance mechanisms would be required to guarantee fund solvency.

The government would continue to guarantee a minimum pension benefit. The minimum pension could be set to a benchmark such as the minimum wage. If upon retirement the balance in an individual's PSA were insufficient to provide an actuarially determined retirement annuity equal to the minimum wage, the government would provide a supplement sufficient to bring the individual's monthly income up to the level of the minimum wage.

Given historic rates of return from the capital markets, even minimum wage earners would receive more than the minimum from the new system if they participated their entire working lives. Therefore, in the absence of a major financial collapse, the safety net would be required for few aside from the disabled and others outside the workforce.

The Chilean Example

The idea of privatizing a public pension system is neither new nor untried. Where privatization has been properly implemented, it has been remarkably successful. One of the best examples is the experience of Chile.

Chile's social security system predated ours, having started in 1926. By the late 1970s its benefit payments were greater than its taxes and it had no funded reserves. On the advice of Milton Friedman and other free-market economists, Chile decided to privatize its system.

The success of Chile's public pension privatization can be measured in many ways. Chile's private savings rate is 26 percent of GDP, compared with 4 percent in the United States. The infusion of capital into the private sector has contributed in large part to Chile's phenomenal 7 percent annual economic growth rate over the past 10 years, double ours.

But most important, beneficiaries are receiving much higher benefits. Since the privatized system became fully operational on May 1, 1981, the average rate of return on investment has been more than 14 percent per year. As a result, the typical retiree is receiving a benefit equal to nearly 80 percent of his average annual income over the last 10 years of his working life, almost double the U.S. replacement value.

Chile's reforms are seen as such a huge economic and political success that countries throughout Latin America, including Argentina, Peru, Colombia, Uruguay, and Mexico, are beginning to implement similar changes. In Europe, Britain provides a low minimum benefit through its traditional pay-as-you-go social security system, but that country has also allowed people to opt out of its benefits above that minimum through contributions to an expanded IRA. Nearly 70 percent of Britons have done so. Even Italy has begun to privatize some aspects of its social security system.

Solving the Problems of Privatization

Obviously, privatization of Social Security would not come without questions and problems.

First, the current Social Security system involves several elements of social insurance that make it much more than a simple retirement system. For example, portions of the payroll tax support the Disability Insurance and Medicare programs. Transferring those programs to the private sector is both possible and desirable but entails considerably more difficulty than privatizing the retirement portion of Social Security. Their fate should be decided separately.

Social Security also currently provides survivors' benefits that would disappear under a privatized system. But that would be largely offset because privatization would make benefits part of an individual's estate.

In addition, it would be relatively easy to use a portion of PSA funds to purchase life insurance.

Finally, it's important to recognize the redistributionist aspect of Social Security. Benefit formulas are calculated on a progressive basis that provides a relatively higher return to low-income workers than to people with higher incomes. A privatized system would generally reverse that. High-wage individuals would receive a higher total return on their investment, which would lead to greater income inequality.

Still, and far more important, low-wage workers would likely receive far more in benefits than they do under the current system. Because low-income workers are far more likely than the wealthy to rely on Social Security for all or most of their retirement income, the current system's low rate of return actually hurts them the most. Indeed, some studies show that because of the regressive nature of the payroll tax and the shorter life expectancy of the poor, they are the major victims of today's system.

The most difficult issue associated with any proposed privatization of Social Security is the transition. Put quite simply, regardless of what system we choose for the future, we have a moral obligation to continue benefits to today's recipients. But if current workers divert their payroll taxes to a private system, those taxes will no longer be available to pay benefits. The government will have to find a new source of funds. The Congressional Research Service estimates that cost at nearly $7 trillion over the next 35 years.

While that sounds like an intimidating figure, much of it is really just making explicit an already existing unfunded obligation. As noted above, the federal government already cannot fund as much as $4.9 trillion of Social Security's promised benefits. Those who claim we cannot afford to finance the transition have yet to explain how they will fund benefits for our children.

Even so, proponents of privatization have an obligation to explain how they would fund the transition. The reality will probably involve some combination of four approaches. The first is a partial default. Any change in future benefits amounts to a default. That could range from such mild options as raising the retirement age, reducing cost-of-living allowances, or means testing benefits to "writing off" obligations to individuals under a certain age who opt into the private system. For example, any individual under the age of 30 who chose the private system might receive no credit for past contributions to Social Security.

The second method of financing the transition is to continue a small portion of the current payroll tax. For example, instead of privatizing the

entire OASI portion of the payroll tax, workers would be allowed to invest 6 or 8 percentage points, with the remainder temporarily continuing to fund a portion of current benefits.

Third, Congress can identify additional spending cuts and use the funds to pay the transition cost. Steve Entin, an economist with the Institute for Research on the Economics of Taxation, estimates that fully funding the transition would require slowing the rate of growth in federal spending by an additional ½ percent beyond currently envisioned cuts, eventually reaching a reduction of from $60 billion to $70 billion per year.

The final proposal often suggested for funding the transition is for the government to issue bonds to current system participants and taxpayers. The present value of the actuarially determined annuity due each system participant may be easily calculated and each system participant could be issued zero-coupon T-bonds maturing at the participant's projected retirement date. The bonds would be placed in each individual's PSA. However, while that has the virtue of making explicit the government's long-term obligations, it is really just an accounting gimmick. Ultimately, the government will still have to find the funds to make good on the bonds.

Social Security privatization is an idea whose time has come. For our children's sake, it can't come too soon.

Suggested Readings

Beard, Sam. *Restoring Hope in America: The Social Security Solution.* San Francisco: Institute for Contemporary Studies, 1996.

Borden, Karl. "Dismantling the Pyramid: The Why and How of Social Security Privatization." Cato Institute Social Security Paper no. 1, August 14, 1995.

Carter, Marshall, and William Shipman. *Promises to Keep: Saving Social Security's Dream.* Washington: Regnery, 1996.

Shipman, William. "Retiring with Dignity: Social Security vs. Private Markets." Cato Institute Social Security Paper no. 2, August 14, 1995.

Tanner, Michael. "Privatizing Social Security: A Big Boost for me Poor." Cato Institute Social Security Paper no. 4, July 26, 1996.

Weinberger, Mark. "Social Security: Facing the Facts." Cato Institute Social Security Paper no. 3, April 10, 1996.

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