4. Social Security

> ***Congress should***
>
> - allow young workers to redirect their payroll taxes to individually owned, privately invested retirement accounts.

In his 1998 State of the Union Address, President Clinton stressed the importance of reforming Social Security and promised to convene congressional leaders in 1999 to craft legislation that would make ''Social Security . . . strong in the 21st century.'' The president called for the American people to join in the discussion of Social Security's future.

The president is right. Social Security is in need of fundamental reform, and that reform must come sooner rather than later. The system's financial problems are deep and coming much sooner than commonly believed. But even more important, young workers are already being denied the benefits of the much higher returns that a privately invested Social Security system would bring. Every day that passes without Social Security reform robs young workers of their future.

The president was also right a few days later when, in a speech at Georgetown University, he called for ''bold experimentation'' in Social Security reform, saying that we must ''be open to new ideas, not be hidebound and believe that we can see the future through the prism of the past.'' Given Social Security's underlying flaws, the usual timid reforms—raising taxes and trimming benefits—not only will fail to fix the problem but will make it worse. In contrast, however, a private, invested Social Security plan would produce enormous benefits for the American people.

Why Privatize Social Security?

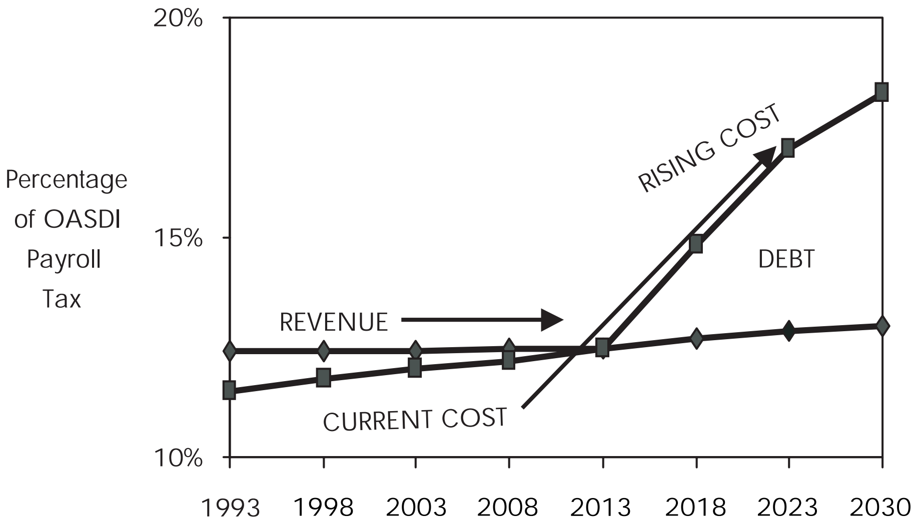
There are five main reasons to privatize Social Security.

Keeping Social Security Solvent

Social Security is going bankrupt. 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. According to the 1998 report of the Social Security system's Board of Trustees, in 2013, less than 15 years from now, the Social Security system will begin to run a deficit (Figure 4.1). That is, it will begin to spend more on benefits than it brings in through taxes. Anyone who has ever run a business—or balanced a checkbook—understands that when you are spending more than you are bringing in, something has to give: you need to start either earning more money or spending less to keep things balanced. For Social Security, that means either higher taxes or lower benefits.

In theory, Social Security is supposed to continue paying benefits after 2012 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide enough money to guarantee benefits until 2032, when it will be exhausted. But one of Washington's dirty little secrets is that there really isn't a trust fund. The government spent that money long ago to finance general government spending and hide the true size of the federal budget deficit. The trust fund now consists only of IOUs—promises

Figure 4.1
Social Security Revenue vs. Cost of Benefits



that at some time in the future the government will replace that money, which can only be done through collecting more taxes or issuing even more debt.

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2032. 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.

Moreover, after that point, the financial gulf in Social Security becomes huge. According to the government's own latest projections, paying all promised Social Security benefits to young workers entering the work force today would probably require a payroll tax increase of from 50 to 100 percent, 6 to 12 percentage points. If we look at all the benefits financed by the 15.3 percent payroll tax today, which include the Hospital Insurance benefits of Medicare, paying all the retirement benefits promised to today's young workers would probably require doubling or almost tripling that tax to as much as 30 or 40 percent. That level of taxation is neither economically nor politically feasible. Consequently, *there is no prospect that today's young workers will receive their currently promised benefits*.

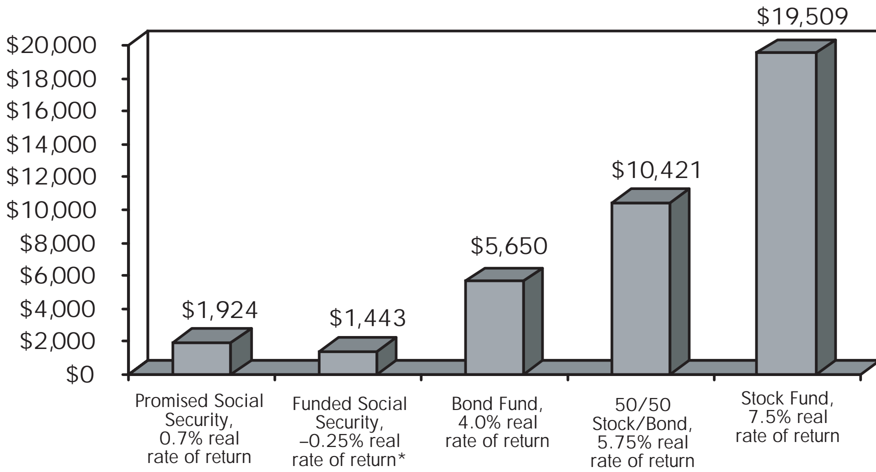
A Better Deal for Young Workers

Even if Social Security did somehow manage to pay all its promised benefits, the taxes paid by today's young workers are already so high that promised benefits would be a bad deal in return for those taxes. Those benefits represent a low, below-market rate of return, or effective interest rate, on the taxes workers and their employers had to pay into the system throughout their careers. Studies show that investing those tax funds instead in private savings and insurance would likely yield three or more times the benefits Social Security promises to today's young workers.

Investing through the private system and earning modest returns, the average two-earner couple would retire with a trust fund of about $1 million in today's dollars to provide their retirement benefits. This trust fund would pay them more than Social Security out of the annual interest alone, while still allowing the couple to leave almost $1 million to their children or other heirs. Alternatively, the couple could use the entire trust fund for an annuity that would pay them three times what Social Security promises (Figure 4.2).

This is a measure of what Social Security is costing average families today—$1 million over their lifetimes, or about three times the benefits

Figure 4.2
Monthly Benefits for a Two-Earner Couple Born in 1968 That Earns a Combined Salary of $60,000



*When this couple retires, the Social Security Administration projects that it will be able to pay only 75 percent of currently legislated benefits.

SOURCE: Cato Institute's calculator at www.socialsecurity.org

of Social Security. Moreover, this financial crisis exists today, not some time in the future. Every year that workers are forced to participate only in Social Security, without the freedom to choose the private alternatives, they are irreversibly suffering a bigger and bigger portion of this lifetime loss. Roughly, the average two-earner couple is losing $25,000 each year they are forced to go without a private option.

These first two problems alone show why privatization is the only solution to Social Security's problems. If taxes are raised or benefits cut to solve the bankruptcy problem, then Social Security will become an even worse deal for today's young workers. Or if taxes are cut or benefits raised to make Social Security a better deal for today's workers, then the system's financial crisis will worsen. The only way to solve both problems is to turn to the private sector, where the high returns and new income generated by private investments will in fact fully finance even better benefits than Social Security promises.

Savings and Economic Growth

Social Security operates on a pay-as-you-go basis, with almost all of the funds coming in 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, reducing 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 as well.

Shifting to a private system, with hundreds of billions of dollars invested in individual retirement accounts each year, would likely produce a large net increase in national savings, depending on how the government financed the transition. This 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 those contributions would be seen as part of a worker's direct compensation, stimulating more employment and output.

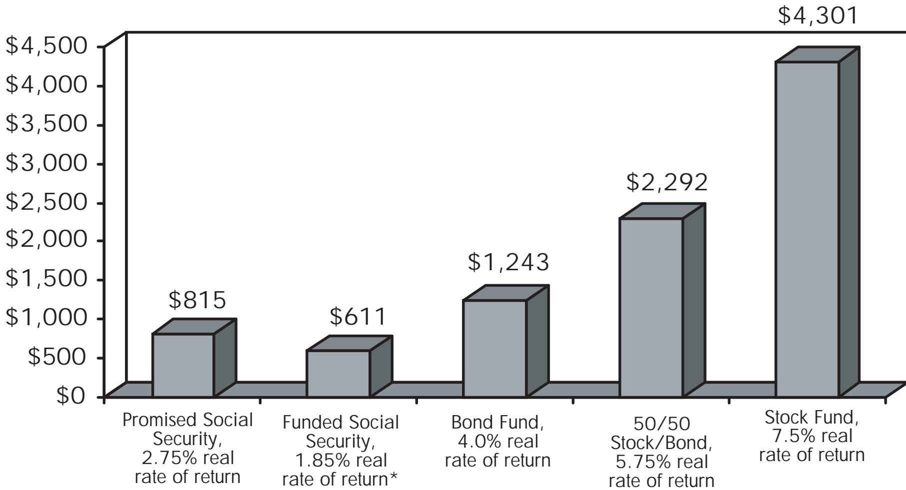
Harvard economist Martin Feldstein estimates that privatization of Social Security would produce $10 trillion to $20 trillion in present value net benefits to America. That is essentially his estimate of the present value of the improved economic performance that would result from the reform. Most of that net benefit would probably come in the form of the 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

Low-income workers would be among the biggest winners under a private system. As shown in Figure 4.3, a private, invested system would pay low-income workers at least two to three times the benefits promised by Social Security. And that does not take into account the fact that blacks and other minorities, and the poor in general, 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. In a private, invested system, by contrast, they would each 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.

The higher returns and benefits of a private, invested system would be most important to low-income families, as they most need the extra funds. The funds saved in the individual retirement accounts, which could be left to the children of the poor, would also greatly help families break out

Figure 4.3
Monthly Benefits for a Worker Born in 1970 Who Earns a Salary of $13,500



*When this worker retires, the Social Security Administration projects that it will be able to pay only 75 percent of currently legislated benefits.

SOURCE: Cato Institute's calculator at www.socialsecurity.org

of the cycle of poverty. Similarly, the improved economic growth, higher wages, and increased jobs that would result from privatization 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 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 privatizing Social Security would turn every worker into a stockowner, the old, senseless division between labor and capital would be eroded. Every laborer would become a capitalist. The socialist dream of the nation's workers owning its businesses and industries would be effectively achieved. At the same time, as the nation's workers became capitalists, support for free-market, pro-growth economic policies would increase in all sectors of society. That

social effect is one of the least cited but most important reasons for privatizing Social Security.

Freedom of Choice and Control

After all the economic analysis, however, perhaps the single most important reason for privatizing Social Security is that it would restore to American workers control over the one-eighth of their earnings that is now consumed by Social Security.

In an ideal world, we would be free to make our own decisions about how to provide for our retirement—how much and when to save. A purely voluntary Social Security system would be consistent with human dignity and individual liberty. However, political reality means that a mandatory retirement system is likely to be with us for the conceivable future. Privatization, therefore, becomes the next best option.

Under privatization, workers would gain direct personal control over the thousands and thousands of dollars they and their employers now must pay into Social Security each year. In addition, in the private market, families would be freer to tailor their retirement and insurance benefits to their own personal needs and circumstances. They would have broader freedom to choose their own retirement age, for example, or the level of life and disability insurance protection appropriate for them.

A Private System

A privatized Social Security system would essentially be a mandatory savings program. Money would still be deducted from a worker's pay and matched by the employer, the same as it is today. But instead of sending that money off to Washington to disappear into the black hole of Social Security, those workers who wished to do so could redirect their money into a personal retirement account (PRA) of their choice.

PRAs would operate much like current individual retirement accounts (IRAs) or 401(k) retirement plans. Individuals could not withdraw funds from their PRAs before retirement, determined either by age or by PRA balance requirements. PRA funds would be the property of the individual, and upon death, any remaining funds would become part of the individual's estate.

PRAs would be managed by the private investment industry, and workers 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 provide a safety net in the form of a guaranteed minimum pension benefit. If upon retirement the balance in an individual's PRA was 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 that level.

Of course, some people might worry that allowing people to invest privately is too risky. But that seriously misstates the risks of both privatization and remaining with the current Social Security system.

Are stocks really risky? In any given year, stocks can go up, but as we have seen recently, they can also go down. For the last several years the stock market has been riding a wave of expansion. A correction was inevitable.

But the year-to-year fluctuations of the market are actually irrelevant. What really counts is the long-term trend of the market over a person's entire working lifetime, in most cases 40 to 45 years. Given that long-term perspective, there is no period in which the average investor would have lost money by investing in the U.S. stock market. In fact, during the worst 20-year period in U.S. history, which includes the 1929 crash and Great Depression, the stock market produced a positive real return of more than 3 percent. The average 20-year real rate of return has been 10.5 percent.

As Sen. Robert Kerrey of Nebraska explains, ''History shows conclusively that long-term investment in the stock market is safe and profitable.''

By comparison, relying on the current Social Security system is extremely risky. Because Social Security is at its core a political system, future benefits are dependent on political decisions. Indeed, the Supreme Court has ruled, in *Nestor v. Fleming*, that individuals have no right to Social Security benefits based on the taxes they've paid. Congress and the president can change or reduce Social Security benefits any time they choose. A young worker entering the Social Security system is gambling on what benefits a Congress and president *45 years from now* will decide to bestow. Given Social Security's already low rate of return to young workers and the system's coming financial shortfall, the political risk of staying in Social Security far exceeds the market risk of private investment.

The Transition

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, it should be understood that this is not a new cost. It is really just making explicit an already existing unfunded obligation. The federal government already cannot fund as much as $9 trillion of Social Security's promised benefits. Privatizing Social Security, therefore, will actually reduce the amount of debt we owe.

The tradeoffs in refinancing a home mortgage provide a useful analogy. There are costs associated with achieving a lower interest rate such as points, title insurance, a title search, attorneys' fees, a credit report, and the like. The decision to refinance is based not only on the lower interest rate but on those costs as well. If the present value of the costs and the lower interest expense is less than the present value of the existing mortgage interest expense, then there is a net benefit from refinancing even though costs are incurred to achieve it. With Social Security, the cost of paying for the transition to a private system will be less than the cost of preserving the current system.

Of course there will be a temporary cash flow problem while we make the transition. We will have to find the revenues to pay benefits to current retirees. While any financing mechanism will be political, involving some combination of debt, transfers from general revenues, asset sales, and the like, the expected budget surplus offers a good place to start. President Clinton has called for using the surplus to save Social Security. If both parties are willing to forgo new spending programs and junk tax cuts, we can begin the transition to a new, improved Social Security system.

In addition to using the budget surplus, there are several methods of financing the transition. For example, a small portion of the payroll tax could be continued temporarily. Workers could be allowed to invest 8 or 10 percentage points (out of 12.4 percent) with the remainder temporarily being used to fund a portion of continued benefits. Congress could also identify additional spending cuts and use those funds to finance the transition. Because much federal government spending is wasteful or counterpro-

ductive, such cuts would not be any sacrifice for society—indeed, the cuts themselves might provide many benefits. A list of potential cuts can be found in Chapter 24. The government could also sell many assets that it currently owns. Finally, the government could issue bonds to spread the cost of transition over several generations. It is important to understand that this is not new debt; it is simply the explicit recognition of an existing implicit debt under the current system.

Public opinion polls show that the American people are ready for fundamental Social Security reform. President Clinton has moved the debate to center stage. Now is the time for Congress to act. There is little that the 106th Congress could do that would have a more profound impact on our economy and the lives of the American people.

Suggested Readings

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

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

Ferrara, Peter, and Michael Tanner. *A New Deal for Social Security*. Washington: Cato Institute, 1998.

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Piñera, José. ''Empowering Workers: The Privatization of Social Security in Chile.'' Cato's Letter no. 10. Washington: Cato Institute, 1996.

—Prepared by Michael Tanner