Cato's Plan for Reforming Social Security

by Michael Tanner

Recently, Washington was sent into one of its periodic spasms of shock and indignation when Federal Reserve chairman Alan Greenspan commented that Social Security cannot continue to pay its promised level of benefits with its currently projected levels of revenue. Greenspan was not saying anything new, but politicians of every stripe reacted as if he had announced that the sun was about to stand still in the sky.

In their latest report the Social Security system's own trustees have reaffirmed the truth of Greenspan's statements. In doing so, they offer us another opportunity to have an honest debate about how to reform Social Security and ensure a safe and secure retirement for our children.

The trustees confirm that Social Security will begin to run a deficit by 2018, just 14 years from now. Thus, while politicians dithered and tried to pretend the issue would go away, we moved another year closer to disaster. But the truly frightening numbers are found further into the report and make clear the magnitude of the fiscal train wreck awaiting us.

The figure most widely cited in the media is the "present value" of Social Security's unfunded liabilities—$3.7 trillion—which is the amount needed to cover shortfalls after the Trust Fund is exhausted in 2042. That number is an increase of $200 billion since the 2003 report. (Present value is the amount that would have to be put away today, at normal interest rates, to fund the coming shortfalls.) An additional $1.5 trillion would be needed to redeem the bonds in the trust funds, for a total unfunded liability of $5.2 trillion over the 75-year actuarial period. Looking at the problem over an infinite horizon, the present value of Social Security's unfunded liabilities is roughly $11.9 trillion. To put this in context, in 2018, the first year that Social Security will run a cash deficit, the shortfall will be approximately $16 billion, or roughly the equivalent of the current budgets for Head Start and the WIC nutritional program. In another two years, Social Security's shortfalls will nearly exceed not just those two programs but also the entire Departments of Education, Commerce, and Interior, and the Environmental Protection Agency. By 2030 or so, you can throw in the Departments of Energy, Housing and Urban Development, and Veterans Affairs. And the biggest deficits would be still to come.

To look at it in terms of taxes, in the first year after Social Security starts running a deficit, the government must acquire revenues equivalent to nearly $200 per worker. By 2042, the additional tax burden increases to almost $2,000 per worker, and by 2078 it reaches a crushing $4,200 per worker (in constant 2004 dollars). 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 2078, or an equivalent increase in income or other taxes.

This doesn't begin to take into account Social Security's other problems: a poor and declining rate of return for younger

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Michael Tanner is director of health and welfare studies, and director of Cato's Project on Social Security Choice. He is the editor of Social Security and Its Discontents: Perspectives on Choice, *recently published by the Cato Institute.*

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been here four years or more, here is your green card.” That was an amnesty. But in this case, the legalized workers would not, and should not, get automatic citizenship or even permanent residency. They would receive only a temporary visa, renewable for a limited time. They would have to pay a fine, which would not be chump change to somebody on a low-skilled wage. They would have to get in line with everybody else to apply for permanent status under existing law.

I think we should be careful to avoid the mistake of previous guest worker programs. It is absolutely essential that these visas be portable. That was the mistake of previous programs. They tied the workers too closely to the employer. It gives the employer too much leverage. The best worker protection is the ability to change jobs and to look for a job that has better conditions and better pay.

As I see it, we have three options before us. We can muddle through with the status quo. Nobody is happy with that. Nobody wants massive illegal immigration. Or we can redouble our efforts. We can quintuple spending again, seal the border, and build a three-tiered wall from San Diego to Brownsville. And that will not solve the problem.

Or we can recognize reality and create a legal channel, so that, in the words of President Bush, willing workers and willing employers can get together to serve the social and economic needs of both our countries.

In his farewell address in 1989, Ronald Reagan said he saw the United States as a shining city on a hill, “God-blessed and teeming with people of all kinds, living in harmony and peace. A city with free ports that hummed with commerce and creativity. And if there had to be city walls, the walls had doors. And the doors were open to anyone with the will and the heart to get here.”

The fundamental, philosophical issue at stake is whether we will keep those doors open to peaceful, hardworking people with the will and the heart to get here, or slam the door shut, at great cost to our economy and our tradition as a free and open society. ■

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workers; the unfairness of the program for minorities and working women; the impact on wealth creation; and, most importantly, the lack of legal ownership and control over one’s benefits.

A Proposal for Individual Accounts

Social Security’s problems have led to a growing movement for reform, including proposals to allow younger workers to privately invest some or all of their Social Security taxes through individual accounts.

Unfortunately, many of these proposals fell short of what was needed to truly fix Social Security. Many proposals contained only tiny accounts, leaving the majority of workers’ retirement income subject to government control. Other plans promised too much, pretending that every retiree could become a millionaire with no cost to the taxpayers and no tough decisions.

Therefore, it was important that Cato’s Project on Social Security Choice develop a plan of our own, a proposal that would substantially transform Social Security into a savings and investment system while being fiscally responsible.

After months of hard work, the advisory committee to Cato’s project proposed the following:

- Current workers should be given a choice: 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. That is to say, they would not be negatively affected by the creation of the individual account option but would not be paid benefits higher than what Social Security can actually pay today.

  Beginning in 2012, the formula used to calculate the accrual of benefits would be adjusted to be indexed to price inflation rather than national wage growth. It is particularly important to note that this change would have no impact on those people who have 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.
- At the same time, 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. Those people who chose 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 continue to be paid into Social Security to pay transition costs and to fund disability and survivors’ benefits.

Workers choosing the individual account option would no longer accrue future benefits under traditional Social Security but would get a zero–coupon bond in recognition of their past contributions to Social Security. The amount of the bond would provide a benefit based on accrued benefits under the current Social Security system as of the date that the individual chooses an individual account. 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.

Funds deposited in individual accounts would be invested in real capital assets under a three-tier system: a centralized, pooled collection and holding point; a limited series of investment options, with a lifecycle fund as a default mechanism; and a wider range of investment options for individuals who accumulate a minimum level in their accounts.

At retirement workers would be able to choose between an annuity, a programmed withdrawal option, or the combination of an annuity and a lump sum payment. In addition, if at any time a worker could purchase an annuity equal to 120 percent of poverty, he

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or she could opt out of the system altogether and stop paying the 6.2 percent individual account contribution.

- Finally, the federal government would provide a safety net ensuring that no worker's retirement income would fall below 120 percent of the poverty level. Workers whose accumulations under the private investment option fall below the amount required to purchase an annuity of that level would receive a supplement sufficient to enable them to purchase that annuity.

Some Social Security reform proposals provide much higher benefit guarantees, pledging that no one will 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 is wrong to make taxpayers responsible for guaranteeing the investments of 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 while being protected from any possible losses.

The Social Security Administration is currently "scoring" our proposal and will provide a detailed analysis of both its long- and short-term impact on the federal budget. But even without that analysis, we can be fairly certain that the our plan will be substantially less expensive than the current Social Security system and will save money in the long run, there will almost certainly be a short-term requirement for additional revenues.

Where will that transitional financing come from? That is a decision for Congress, which must weigh the relative merits of debt, spending reductions, and increased revenues. But a good starting point would be for Congress to cut corporate welfare and redirect the savings to Social Security.

It is also important to remember that the financing of the transition is a one-time event that actually serves to reduce 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 would not increase the amount of spending necessary. 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 Social Security structure in place and allow workers to privately invest just two to three 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 retirement between markets and government, combining defined contribution and defined benefit programs; or
- Concern over short-term annual cash deficits.

Given the clear advantages of larger accounts, however, none of those reasons holds up.

First, small account size is unlikely to protect proponents of individual accounts from political attack. The recent Medicare reform debate provides a useful example. Despite rollbacks on attempts to introduce market competition to Medicare (the final bill contained only a handful of "demonstration projects," which 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 of 6.2 percent accounts.

Moreover, small account proposals may prove politically counterproductive by dissipating the enthusiasm of grassroots activists and others supporting 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. And larger accounts will generate more enthusiasm.

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 the risk argument generally attach greater 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, this misreads both market and political risks.

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

Those concerned with short-term annual cash flows acknowledge that large accounts would save money in the long run but are also concerned with maintaining the program's financial balance on an annual basis. This concern comes both from wariness over the size of projected annual budget deficits and skepticism about the federal government's ability to use money saved in the future to repay debt incurred during the transition rather than for tax cuts or new spending programs. And Congress's recent spending habits have given those skeptics real cause for concern.

However, focusing on short-term cash flows only may be penny wise and pound foolish. It is much like making only the minimum payment on a credit card, while neglecting to pay off long-term debt. Large

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account plans do incur greater short-term costs, but they also result in greater long-term savings.

But 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 for increased rates of return and higher benefits, correct the inequities of the current system in order 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 these measures, large accounts do a far better job of achieving true reform.

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, why not allow workers to privately invest the full 12.4 percent payroll tax, or at least the roughly 10 percentage points used for retirement 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 on Social Security for their retirement income. In fact, the wealthiest fifth of retirees receives only 20 percent of its income from Social Security. These 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 these 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 investment freedom.

Finally, some observers have suggested progressive accounts, with low-income workers able to invest a higher proportion of their payroll taxes than those with higher incomes. There is a great deal of appeal to such an approach. It would maximize the benefits of individual accounts to low-income workers while holding down overall transition costs and avoiding the problems of over-saving on the part of higher-income workers.

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

One last point: a 6.2 percent account is a very easy concept to explain to the average worker. The worker could privately invest half of his or her 12.4 percent payroll tax while the employer's half would be 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 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, is clear, concise, and easy to understand in an age of eight-second sound bites.

Ownership and Control

Although more and more Americans agree on the importance of giving younger workers an opportunity to invest their Social Security taxes privately, advocates of individual accounts have been increasingly divided over how large those accounts should be. Some proposals recommend large accounts but have very large transition costs, diminishing their political viability. Other proposals are less expensive but give workers control and ownership over only a small portion of their retirement funds. The Cato plan distinguishes itself by offering large accounts while protecting future generations of workers and taxpayers. It would restore Social Security to long-term and sustainable solvency and would do so at a lower cost than that of simply propping up the existing program. ■

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