CATO INSTITUTE BRIEFING PAPERS

The Archer-Shaw Social Security Plan
Laying the Groundwork for Another S&L Crisis

by Andrew G. Biggs

No. 55 **February 16, 2000**

The Social Security reform plan proposed by Reps. Bill Archer (R-Tex.) and Clay Shaw (R-Fla.), chairmen, respectively, of the House Ways and Means Committee and its Subcommittee on Social Security, is a compromise between a Clinton administration plan to let the government invest workers' payroll taxes in the market and congressional proposals to let individuals invest their payroll taxes in personal market-based accounts. Government investment has been criticized for the possibility of political influence on investment decisions, while personal accounts face attack for making individuals shoulder the burden of market risk. The Archer-Shaw plan is an attempt to satisfy critics of both approaches.

The Archer-Shaw plan would let individuals make investment decisions, thereby reducing the likelihood of political influence, but the government would be required to protect workers against any losses. The plan's proposal to privatize profit and socialize risk resembles the incentive structure that led to the 1980s savings and loan crisis, which cost taxpayers hundreds of billions of dollars. That incentive structure creates what economists call "moral hazard" and could again lead to large taxpayer liabilities if allowed to take root in the Social Security system.

Andrew G. Biggs is a Social Security analyst at the Cato Institute.

The Archer-Shaw proposal, like the legislation passed to resuscitate the failing S&L industry, introduces moral hazard.

Introduction

In the 1980s the American savings and loan industry faced a crisis. In response, Congress passed legislation designed to enable S&Ls to earn higher profits. But to protect the American people, Congress shielded customers from losses. The result: reckless investment and hundreds of billions of dollars in past and future taxpayer liabilities.[1] Now Congress is considering a plan that could usher in similar risks for Social Security.

The Social Security reform plan proposed by Reps. Bill Archer (R-Tex.) and Clay Shaw (R-Fla.), chairman, respectively, of the House Ways and Means Committee and its Subcommittee on Social Security, is a compromise between two competing approaches to reform.[2] The Clinton administration has proposed government-directed investment of workers' payroll taxes in the stock market, while most congressional plans would let workers invest their own payroll taxes in personal retirement accounts. Government investment has been criticized for the possibility of political influence on investment decisions, and personal accounts face attack for making individuals shoulder the burden of market risk. The Archer-Shaw plan is an attempt to satisfy critics of both approaches. That plan would let individuals make investment decisions, thereby reducing the likelihood of political influence, and it would protect workers against any losses. But the plan's proposal to privatize profit and socialize risk resembles the incentive structure that led to the S&L crisis of the 1980s, which cost taxpayers hundreds of billions of dollars. This incentive structure creates what economists call "moral hazard" and could again lead to large taxpayer liabilities if allowed to take root in the Social Security system.

The Archer-Shaw proposal, like the legislation passed to resuscitate the failing S&L industry, introduces moral hazard: insurance against risk causes risk taking to increase. In both cases, the federal government—and thereby American taxpayers—bears the associated costs.

The Archer-Shaw proposal provokes debate among both supporters and opponents of Social Security privatization. This paper focuses on only one aspect of the Archer-Shaw plan: its creation of moral hazard.

A Primer on Moral Hazard

Economists use the term "moral hazard" to denote "the presence of incentives for individuals to act in ways that incur costs that they do not have to bear."[3] In practice, that means that when an individual is insured against the costs of a given event, that event becomes more likely to occur. For moral hazard to exist, two criteria must be satisfied:

- first, the individual must have at least partial control over whether the insured-against event takes place; and
- second, in the absence of insurance, the costs associated with that event would cause the individual to take steps to prevent it.

For instance, an automobile driver has at least some control over whether he will get into an accident. The risk of accidents generally causes a driver to take precautions, such as driving slowly and not venturing out in bad weather. The two general criteria being satisfied, insurance against that risky event will tend to increase the likelihood of the event's taking place. To illustrate, ask yourself if you would drive more carefully if you did not have collision insurance for your car. If the answer is yes, then moral hazard is at work.

Moral hazard can occur in many different circumstances. For instance, moral hazard means that fire insurance can increase fires, mandatory safety belt laws can increase automobile accidents, and disability insurance can lead to more people becoming disabled.[4]

Moral hazard does not necessarily mean that people intentionally cause the insured-against event to occur. It merely means that people may take fewer precautions against

that risk. Most insurance policies therefore contain provisions designed to combat moral hazard. Deductibles and copayments, for instance, make the insured person share some losses; other policies simply limit the types of activities they will cover. In the absence of such safeguards, however, moral hazard can generate considerable losses for insurers.

Origins of the S&L Crisis

The S&L crisis of the 1980s is a striking example of the damage that moral hazard can inflict. S&ls (also known as thrifts) are deposit-taking financial institutions specializing in home mortgage loans. The kindly manager, epitomized by Jimmy Stewart in *It's a Wonderful Life*, held families' long-term savings while lending them money to purchase homes. But beginning in the 1970s, both the nature and the image of the industry began to change. S&Ls suffered from interest rate mismatches between their assets and liabilities. They were paying substantially higher interest rates to depositors than they were earning from mortgage loans issued years earlier. As a result, hundreds of institutions were in danger of going under.[5]

There was little that could quickly alter the underlying economic conditions, so state and federal legislators faced an unattractive choice: shut down failing S&Ls, at a substantial cost to taxpayers, or help S&Ls become more profitable and recover on their own.[6] To their later regret, Congress and many state governments chose the latter course, letting S&Ls expand out of low-profit mortgage loans into potentially more profitable—but riskier—consumer and commercial loans, leases, and other business activities.[7] Congress also lowered capital requirements, which cushion against losses and put a portion of the owners' own funds at risk. That change kept otherwise insolvent S&Ls alive and gave them additional capital to invest in newly available business opportunities. The government also allowed healthy S&Ls to acquire insolvent institutions without recognizing their losses on their balance sheets. That created larger S&Ls whose assets consisted partly of "supervisory goodwill" rather than real financial resources.[8]

To protect consumers, in 1980 Congress increased deposit insurance protection from $40,000 to $100,000.[9] As a result, government soon bore an increased share of the increased risks that S&Ls were taking.

Moral Hazard in the S&L Crisis

The expansion of deposit insurance along with reductions in capital requirements, liberalization of lending policies, and general laxity of regulatory oversight created what Richard Herring, professor of finance at the Wharton School, called "the classic example of moral hazard."[10] S&L operators and their customers reaped the gains from new investments while the government bore the costs when investments failed.[11] Consequently, neither financial institutions nor their customers felt compelled to monitor the risk of the new business activities. The National Commission on Financial Institution Reform, Recovery and Enforcement recounted the dangers in this situation:

> There were huge potential gains available to S&L managers, unconcerned with safety and soundness, who were willing to grow rapidly into lucrative but risky ventures. With little, if any, of their own financial resources at stake, operators had a license to use insured deposits to engage in risky ventures. This was not a matter of having "no choice," but it was a rational pursuit of large potential gains. The downside risk of operators' investments had been nationalized through [deposit insurance] while the potential upside was in private hands. It was perfectly rational to pursue risk, not only to survive—but also for the potential of enrichment.[12]

The S&L crisis was the result of well-intentioned politicians who thought they saw an easy way out and bankers who accepted their generosity.

Bank regulators, who were responsible for monitoring institutions' risk taking, often encouraged S&Ls to take greater risks, since increased returns were the only way to restore the industry's solvency.

For S&L regulators, says Bill Popejoy, a California S&L executive in the 1980s, "it was denial. It was 'God, I hope this savings and loan mess goes away.'"[13] But opportunities for profit coupled with protection from loss did not make the problem go away. They made it worse. By 1988 failing investments pushed half of all S&Ls into or close to insolvency. The S&L cleanup shut down some 750 institutions and cost taxpayers as much as five times the inflation-adjusted cost of bank failures during the Great Depression of the 1930s.[14]

Contrary to public perceptions, the S&L crisis was not primarily about crooked bankers colluding with corrupt politicians. The NCFIRRE report insisted that "it is important to realize that fraud was not the cause of the S&L debacle" and concluded that criminal activity accounted for only 10 to 15 percent of total monetary losses.[15] Cato Institute adjunct scholar Bert Ely puts criminal losses as low as 3 percent.[16] Instead, the S&L crisis was the result of well-intentioned politicians who thought they saw an easy way out and bankers who accepted their generosity, to the tune of hundreds of billions of taxpayer dollars. NCFIRRE executive director James L. Pierce declared: "The risk-takers, high-flyers and crooks did not just descend on the industry. They were attracted to it unwittingly by government policy."[17]

Americans still express support for Social Security's ideals, but few have confidence in its future.

Social Security Faces Its Own Insolvency

Like the S&L industry, Social Security is a venerable American institution in trouble. Americans still express support for Social Security's ideals, but few have confidence in its future. Just as S&Ls suffered from high interest rates, a changing demographic and economic environment means that Social Security's pay-as-you-go financing faces multi-trillion-dollar payroll tax shortfalls. By 2035, the Social Security Administration predicts, the program will be capable of paying less than three-quarters of promised benefits.[18]

Awareness is growing that Social Security's future problems cannot be addressed as past crises were—through benefit cuts, tax hikes, or increases in the retirement age. Those steps would further lower Social Security's already low rate of return to retirees, making it a worse deal than it already is. In his statement at the White House Conference on Social Security on April 7, 1998, President Clinton recognized this new thinking when he identified a low rate of return as one of Social Security's fundamental problems.[19] At a July 20, 1998, town hall meeting in Albuquerque, New Mexico, Clinton suggested that a solution to Social Security's financing problems could lie in "the higher return on investment" in private capital markets.[20]

In his 1999 State of the Union Address, President Clinton introduced a plan for a government-appointed board to invest a portion of current payroll taxes in stocks. The Clinton plan met with robust opposition. Federal Reserve Board chairman Alan Greenspan criticized the proposal for creating the danger that politically motivated legislators and "rent-seeking" special interests would collude to channel investment toward their own ends rather than those of the public. "Even with Herculean efforts," Greenspan said, "I doubt if it would be feasible to insulate . . . the trust funds from political pressures—direct and indirect—to allocate capital to less than its most productive use."[21] Experience with state government pension funds, which have divested some investments for political reasons while making others to benefit local industries, lends credence to those fears.[22] In March 1999 the Senate passed by a vote of 99–0 a resolution opposing any government-directed investment of Social Security funds.[23]

In contrast, many reformers propose that individuals, rather than government, do the

investing. Personal retirement accounts, through which individuals invest part or all of their payroll taxes in stocks, bonds, or other assets, would increase Social Security's rate of return. And since individuals would control their own assets and invest toward their own financial goals, personal accounts would avoid the political risks of government investment. Nevertheless, personal accounts have not gone without criticism.

Opponents of personal accounts contend that they "expose individuals to a variety of risks, any one of which can shrink their retirement benefits and a combination of which can nearly wipe them out."[24] The true risks of investments in stocks and bonds have been overstated by opponents of personal accounts.[25] Nevertheless, the perception of risk has made personal accounts more difficult to sell politically.

A second problem is that personal accounts' higher returns would not, by themselves, eliminate the need for tax increases or benefit cuts. If the diversion of payroll taxes to personal accounts reduced benefits on a proportional basis, the future gap between Social Security's payroll tax assets and its benefit liabilities would remain constant. To illustrate, imagine a reform plan under which 2 percent of wages were diverted to a personal account and future benefits were reduced proportionately. In the future, tax revenues and benefit payments would be reduced by the same amount, so the difference between them—and the need for tax increases or benefit cuts to close the gap—would not be changed.[26]

The Archer-Shaw plan attempts to satisfy objections to both government investing and personal accounts while capturing the increased rates of return on market investment to bolster Social Security's finances:

> Our plan is designed to be politically feasible. Realizing that Social Security reform cannot happen without bipartisan support, we are offering a plan that builds on areas of bipartisan consensus and bridges the gaps between ideological differences. The plan fully maintains the current safety net and fully shields individuals and their benefits from market risk. However, it creates individual accounts so that benefits can be funded in advance with real savings.[27]

Archer and Shaw's political compromise has the potential to create moral hazard, which led to billions of dollars in losses during the S&L crisis.

The Archer-Shaw Proposal

To avert the politicization of capital markets, Archer declares that, "as a matter of principle, Uncle Sam should not be making private investment decisions for you."[28] Instead, Archer and Shaw propose that the government deposit 2 percent of workers' wages subject to payroll taxes in personal accounts controlled by the workers.[29] The worker would invest those deposits in one of more than 50 competing private stock and bond investment funds,[30] where they would build value over time.

The defining feature of the Archer-Shaw plan is its "clawback." When a worker reaches retirement, he returns his account balance to the government. The government uses those funds to pay the worker the full benefits to which he is entitled under current law. The higher returns from personal accounts are clawed back into Social Security, providing funds so the program can continue to pay full benefits without increased taxes.

Archer-Shaw's clawback accomplishes two goals. First, it integrates personal accounts into Social Security's guaranteed defined-benefit structure. The worker receives his full Social Security benefit even if his account's investments perform poorly, thereby shifting market risk from individuals to the government. If an account loses money, the government rather than the worker absorbs the loss. Maintaining Social Security's traditional benefit guarantee might placate those who

The true risks of investments in stocks and bonds have been overstated by opponents of personal accounts.

We must assume that workers will seek to do as well for themselves as possible.

oppose personal accounts because of market risk, however slight that risk might be in practice.

Second, by capturing the higher returns from personal retirement accounts, Archer-Shaw's clawback minimizes the need for tax increases or benefit cuts. Unlike a proposal that reduces future benefit payments by the amount going into the account, Archer-Shaw's clawback reduces traditional benefit payments by the amount that comes out of the account after it has been invested in higher-yielding stocks and bonds. The larger the account balance, the smaller the amount that Social Security must pay out of its own funds. The clawback enables Archer and Shaw to boast of "saving and strengthening Social Security without raising taxes or cutting benefits."[31]

However, there is one important exception to the clawback. If a worker's personal account balance grows large enough to pay benefits higher than those promised by Social Security, the worker may be able to convert his account to an annuity[32] rather than receive his standard benefits from Social Security.[33] This provision could attract support from those who favor personal accounts because of the potential for increased retirement incomes, since workers could see gains from personal accounts without being subject to the losses. This provision, we will see, is a central weakness of the Archer-Shaw proposal.

Moral Hazard in Archer-Shaw

If the market falls, workers are protected, but if the market does very well, workers receive extra benefits. All this sounds almost too good to be true. It is. Enter moral hazard. To find moral hazard in Archer-Shaw, we need merely look at how rational individuals would treat the investments in their personal accounts.

People invest to make money. Indeed, the efficiency of private markets is premised on the idea that self-interest drives individuals to allocate capital in the most profitable, and hence the most productive, manner. Consequently, we must assume that workers will seek to do as well for themselves as possible.

In practice, workers would search out investments with rates of return high enough to provide extra benefits at retirement. Let us call this rate the "bonus return": if the return on a worker's account averaged at least this rate, the worker would receive additional benefits.

Reflecting his opposition to government investment, Archer says that, "if there is to be investment in the markets, it must be under the control of individuals, free to make up their own minds."[34] To that end, Archer-Shaw allows workers to choose among at least 50 competing investment options. But how would investment providers attract customers? Administrative fees for Archer-Shaw's accounts are capped at 0.25 percent of assets, so investment companies could not afford to offer extensive services even if workers desired them.

In truth, there is one and only one area in which the investment companies would compete: the bonus return that brings extra benefits. Nothing else matters, because nothing else affects the benefits a worker will receive at retirement. Just as depositors were drawn to S&Ls offering higher interest rates on deposits, workers will be drawn to investment companies promising to achieve the bonus return. To attract business, investment companies will offer investments that have the best chance, however small, of reaching that level.

But what would the bonus return be? And would attempts to reach it cause losses? There is no definitive answer to those questions. Older workers, with less time to build an account balance, would have to earn a higher rate of return. Men would need to earn a somewhat lower rate of return than women would, because they have shorter life expectancies and can purchase annuities at a lower price.

Let us use one example to get a rough idea. The Social Security Administration recently released a new benefit statement estimating the retirement benefits an individual would be entitled to receive. SSA uses the example of "Wanda Worker," a female born in 1960 who earns $30,364 annually. Assuming her income continues unchanged, at age 67 she would be entitled to $1,096 per month.[35] So, for Wanda to receive extra benefits under Archer-Shaw, her personal account would need to provide the money needed to purchase an annuity that paid at least $1,096 per month.

In 1995 the average monthly benefit from a joint-and-survivor annuity, which provides spousal protections roughly equivalent to those of Social Security, was $6.48 per $1,000 of premium costs.[36] That is to say, a $100,000 lump sum payment at age 65 could purchase an annuity paying $648 per month for life.[37] An annuity paying Wanda's estimated retirement benefit of $1,096 per month would cost $169,136. To receive extra benefits, therefore, Wanda would need to retire with an account balance in excess of $169,136. Assuming Archer-Shaw took effect in 2000, she would have 27 years in which to amass that sum. To save $169,136 with an account funded with 2 percent of Wanda's wages would require a real annual return of 13.7 percent.

Despite extraordinary market performance in recent years, it is unlikely that Wanda could achieve this bonus return through ordinary stock index funds or balanced mutual funds. Stock returns have averaged 7 percent since 1802 and 7.5 percent since 1946.[38] The highest average return over 20 years for the stock market as a whole has been only 12.6 percent; over 30 years, it drops to 10.6 percent.[39] Past market performance indicates that the bonus return for most workers under the Archer-Shaw plan is so high that the Heritage Foundation's Daniel J. Mitchell predicts that "the number of workers with excess funds will be zero."[40]

But that's not the end of the story. In fact, it's only the beginning. The fact that most workers won't achieve the bonus return does not mean that they won't try. And why shouldn't they? Archer and Shaw boast that the plan's benefit guarantee "enables us to shield individuals and their benefits from market risk . . . *all risk is borne by the government, not the individual*."[41] Like bank customers during the S&L crisis, workers under Archer-Shaw would have everything to gain and nothing to lose.

Under Archer-Shaw rational workers would invest with the sole aim of earning very high rates of return, however unlikely that might be. A financial adviser, if acting on his fiduciary oath to "act in good faith and in the best interests of the client,"[42] would recommend that course. Because of Archer-Shaw's perverse incentives, resources "under the control of individuals, free to make up their own minds" would flow toward volatile investments such as Internet and technology stocks, emerging markets, and the like rather than toward broad-based mutual funds. Volatile investments would likely produce either higher gains or higher losses than would balanced funds. As with S&Ls during the 1980s, the gains would flow to investors while Uncle Sam—and consequently American taxpayers—would pick up the tab for any losses.

It is hard to say with precision how big those losses could be. The Archer-Shaw plan assumes that personal accounts will return a real average of 5.6 percent annually (not including management fees, capped at 0.25 percent). If that rate of return were maintained, Social Security's long-term deficit would be eliminated and payroll tax rates could gradually be reduced beginning in 2040. Archer-Shaw's "break-even" return (at which Social Security's long-term deficit is eliminated but payroll tax rates cannot be reduced over the long term) is one percentage point lower, at 4.6 percent annually.[43] If even 20 percent of Archer-Shaw's personal accounts reaped 0 percent returns (meaning that they neither gained nor lost value), Archer-Shaw would fail to meet its basic financial goals.[44] Should the number of underperforming accounts increase and the

Workers under Archer-Shaw would have everything to gain and nothing to lose. They would invest with the sole aim of earning very high rates of return.

Archer-Shaw threatens to recreate the very "political risk" it was designed to avoid.

size of losses grow larger, taxpayers could face financing problems far greater than those currently posed by Social Security.

To hope that risky investment and account losses would not arise because workers under the Archer-Shaw plan would not act in their own best interests is akin to S&L regulators in the 1980s hoping the problem would "just go away." The NCFIRRE's Pierce said of the S&L crisis, "There was a perverse incentive to gamble—heads you win, and tails, the taxpayer will pay the loss."[45] Archer-Shaw's incentive structure is no different.

A Return to Government Investing

The Archer-Shaw plan appears to implicitly recognize its moral hazard problem and attempts to address it. But in doing so, Archer-Shaw retreats toward the government-directed investing of the Clinton administration's proposal and threatens to recreate the very "political risk" it was designed to avoid.

Archer-Shaw contains three requirements designed to manage investment risk. First, the personal accounts in Archer-Shaw must be invested 60 percent in stocks and 40 percent in corporate bonds. But a mixed portfolio would by itself do little to control risk taking. What would prevent a fund made up of 60 percent Internet stocks and 40 percent junk bonds?[46] In fact, a mixed-portfolio requirement could even aggravate risk, since workers seeking to achieve the bonus return would compensate for lower bond yields by choosing higher-yielding—and therefore riskier—stocks.

Second, workers are required to invest in index funds, which have a reputation for safety and stability.[47] The assumption that index funds are inherently low risk reveals a misunderstanding of indexing, which simply means buying all of the stocks or bonds in the chosen class rather than actively predicting winners and losers. The stability of an index fund is wholly dependent on its underlying assets, such as the S&P 500 index that underlay the original Vanguard index fund. Today there are index funds for a dizzying array of investment indices: from precious metals, to the gas industry, to a Malaysian index (three-year return: negative 40 percent), to the "death-care" industry of funeral homes and burials, to a fund investing only in stock car racing.

More to the point, some index funds are explicitly geared toward increased volatility and risk, which is precisely what a rational investor under Archer-Shaw would seek. For instance, the Potomac Dow 30 Plus Fund and the Potomac Internet Plus Fund track the Dow Jones industrial average and the Dow Jones composite internet index, respectively. By entering into futures contracts and options, those funds seek "to produce daily results that correspond to 125% of the performance, either positive or negative," of the respective index.[48] This type of enhanced volatility index, or one producing even higher risk, is the sort of fund one would expect to see under Archer-Shaw.

Third, workers are restricted to only *"pre-approved, low-risk, investment options."*[49] But since workers under Archer-Shaw would have every incentive to seek out high-risk investment products, and investment companies would have every incentive to provide them, ordinary regulatory guidelines like those applied to individual retirement accounts (IRAs) and employer-provided 401(k) plans would be insufficient to curtail risk taking. For instance, under so-called self-directed IRAs, individuals can invest in individual stocks as well as assets such as precious metals, real estate, limited partnerships, and viatic settlements (the purchase of the life insurance policy of a terminally ill patient). In fact, there is little to prevent an individual from "day trading" with his IRA account.

Even the more restrictive rules on 401(k) offerings would not limit risk taking if applied to the Archer-Shaw plan.[50] In practice, employers restrict the aggressiveness of the investment options they offer through 401(k) plans because of the employer's fidu-

ciary responsibility to employees participating in the plan, which can result in the employer's sharing in an employee's investment losses if the investment options provided are not "prudent."[51] In other words, market discipline—imposed on both the employee-investor and the employer—dictates the risk of the investment options offered and accepted, not specific regulations of the law itself.

For those reasons, Archer-Shaw's investment approval process, overseen by a new Social Security Guarantee Board, would have to go far beyond the basic regulations and consumer disclosure associated with IRA and 401(k) investment programs. It could easily extend to the point of regulating the returns on individual accounts.[52]

Archer-Shaw's approval process therefore presents a threat similar to the one posed by President Clinton's plan for direct government investment controlled by a board of impartial investment advisers. Greenspan's objection to government-directed investment is that it *inevitably* invites political pressure that distorts capital markets and risks taxpayer losses. Archer and Shaw explicitly reject government investment of Social Security funds, yet Archer-Shaw's investment approval process could allow effective government control over ostensibly private investment decisions.[53]

It is worth noting that, even if Archer-Shaw's approval process could effectively curb risky investment while avoiding political influence, it would be self-defeating. "Safe" investment would practically eliminate the possibility of workers receiving extra benefits, which Archer and Shaw have promoted as an advantage of their plan. Workers without the chance to profit by their investments lack any incentive to monitor the performance of those investments. Hence, returns on such investments would likely be below market averages, possibly leading to a future revenue shortfall. (Recall that account returns of one percentage point or more below market averages would render Archer-Shaw non-self-financing.)[54] Moreover, persistent market underperformance is indicative of the misallocation of capital, which would reduce the ancillary economic benefits of private investment that Archer and Shaw have touted.[55]

Archer-Shaw presents a choice between two evils: moral hazard on one hand and de facto government investment on the other. If, under Archer-Shaw, individuals cannot be allowed to choose their own investments, then government-controlled investment—and the corruption, government influence on capital markets, and taxpayer losses that potentially accompany it—is the only alternative.

What Separates Archer-Shaw's Moral Hazard from That of Other Plans?

In defense of Archer-Shaw, it could be said that any Social Security plan incorporating personal accounts in conjunction with a guaranteed minimum benefit creates an element of moral hazard. For instance, Joseph J. Cordes and C. Eugene Steuerle of the Urban Institute warn:

> Privatization proposals that would allow individuals to "keep" gains from private accounts in good times but require the government to maintain a floor in bad times would encourage individuals to take excessive risk. The consequences to the government would be similar to those when the savings and loan financial sector essentially went bankrupt.[56]

But there are two possible modifications to Archer-Shaw that would allow personal accounts to be combined with a guaranteed minimum benefit without creating moral hazard.

The first change is to replace Archer-Shaw's combination of a 100 percent clawback and bonus benefits with a clawback of less than 100 percent, which would pay extra

Archer-Shaw presents a choice between two evils: moral hazard on one hand and de facto government investment on the other.

benefits to all workers regardless of the returns on their personal accounts. The second is to retain Archer-Shaw's basic benefit structure but increase the size of the personal account so that the bonus return need not be so high. Neither would fix the more general flaws in the Archer-Shaw approach, but both would ameliorate Archer-Shaw's moral hazard problem.[57]

The first modification is found in a plan proposed by Harvard economist Martin Feldstein.[58] His plan, which introduced the clawback approach, is the base on which Archer-Shaw is constructed. Like Archer-Shaw, the Feldstein plan contains personal accounts (2.3 percent of wages) with a guarantee that no one will receive less than promised under current law. But instead of clawing back 100 percent of the personal account (coupled with additional benefits for those reaching the bonus return), the Feldstein plan has a 75 percent clawback. Seventy-five percent of the personal account would help fund promised Social Security benefits, while the other 25 percent would be additional retirement income. For instance, an individual entitled to $1,300 per month from Social Security and holding an account capable of paying $800 per month would receive a total monthly retirement income of $1,500. Three-quarters of his account would help fund his promised benefit, while an extra $200 would derive from the 25 percent remaining.

Two possible modifications to Archer-Shaw would allow personal accounts to be combined with a guaranteed minimum benefit without creating moral hazard.

That would combat moral hazard by giving workers a personal stake in the success or failure of their accounts. In contrast to Archer-Shaw, a worker under the Feldstein plan would not have to earn astronomical rates of return to reap higher benefits upon retirement. Twenty-five percent of the personal account is his to keep, regardless of the total size of his account. Likewise, unlike Archer-Shaw, under which investment losses would not affect a worker's retirement income, the Feldstein plan makes the worker share in losses as well as gains. If the account performed poorly or lost money, the worker would receive less extra income at retirement. For those reasons, workers would be likely to manage their accounts no differently than they would ordinary investments, with an eye to maximizing returns and minimizing risks.

For instance, a worker making a constant $29,000 a year throughout his life and receiving the stock market average of 7 percent annually for 45 years would add $341 to his monthly retirement income (at average annuity prices) under the Feldstein plan. If that individual's account returned only 2 percent, his extra retirement income would amount to only $78 per month. Just as capital requirements for financial institutions cause operators to put their own money at risk, thereby sharing in the gains or losses of their institution's investments, so a limited clawback such as the one in Feldstein's plan would ensure that workers' investment decisions directly affected their retirement incomes.

That is not to say that the Feldstein plan has no potential for moral hazard. Clearly, a 100 percent clawback like Archer-Shaw's produces moral hazard. Just as clearly, a 0 percent clawback, in which the individual reaps all gains and suffers all losses, would not produce moral hazard. When the clawback lies between 0 and 100 percent, the level of moral hazard will differ from person to person. Some observers have suggested that the clawback must fall below Feldstein's 75 percent before moral hazard is quashed.[59] Yet it seems clear that workers with a true stake in the performance of their accounts—one that can make a difference in retirement income of hundreds of dollars per month—will make more thoughtful investment decisions than they would if no such stake existed.

An important additional consideration is the size of the personal accounts. Since Archer-Shaw's personal accounts contain only 2 percent of wages, out of total payroll taxes of 12.4 percent, accounts must receive a very high rate of return in order to produce higher benefits than those promised by Social Security. If the percentage of wages deposited in the accounts grew, however, the bonus return needed to receive extra benefits would fall.

Let us return to Wanda Worker, the 40-year-old who would need to earn 13.7 percent on her 2 percent personal account in order to receive extra benefits. If, however, the account were funded with 5 percent of wages, the bonus return would be 8.9 percent, still high by historical standards. With personal accounts funded with 10.6 percent of wages (the amount allotted to the Old Age and Survivors portion of Social Security), the bonus return would be only 4.5 percent annually. If Wanda could save 10.6 percent of her wages for a full 45 years, the bonus return would fall to 0.7 percent.[60] With larger personal accounts, the prospect of receiving increased benefits is much higher. Workers have a greater stake in the responsible management of their accounts and reduced incentives to take large investment risks.

The disadvantage of both of those approaches from a political point of view is that they require more money up-front. The 75 percent clawback under the Feldstein plan deprives Social Security of 25 percent of the account's balance, leaving Social Security short by 0.6 percent of wages.[61] Likewise, a personal account funded with 10.6 percent of wages would create an immediate funding deficit. That "lost" money would have to be made up through tax increases, benefit cuts, or reductions in other government spending, steps that Archer and Shaw take pride in not requiring. Archer proudly touts the "cornerstones" of their plan: "It does NOT cut benefits, it does NOT raise taxes, but it DOES SAVE SOCIAL SECURITY."[62]

Moreover, neither the Feldstein plan nor a modified Archer-Shaw with larger personal accounts is perfect, even if they avoid Archer-Shaw's moral hazard problem. Like Archer-Shaw, they give workers no property right in their personal accounts and tap large amounts of general revenue. But the presence of moral hazard in Archer-Shaw transforms an approach that is less than perfect to one that is unacceptably risky.

An investor who suffers losses along with gains will rationally seek the maximum expected return on his investments, that is, the combination of risk and return that will reap the largest long-term gains. When an investor does not suffer losses and must reap large gains to see any personal benefit, as under Archer-Shaw, he will seek out the maximum potential return on his investments regardless of risk. To avoid moral hazard, a Social Security reform plan incorporating personal retirement accounts must give workers a stake in both the gains and the losses of the accounts under their control. Archer-Shaw fails to do so.

Conclusion

The Archer-Shaw Social Security proposal attempts to safeguard a program facing structural problems as serious as those that confronted the S&L industry in the early 1980s. Social Security, as did the S&Ls, faces insolvency as a result of a changing economic environment. But Archer-Shaw seems not to reflect the lessons of the disastrous S&L resuscitation plans. Archer-Shaw is caught between the Scylla of government-directed investment, which risks political interference and financial losses, and the Charybdis of market risk, which many people deem too dangerous for workers to manage. Archer-Shaw collides with moral hazard, the incentive structure at the root of the mammoth financial losses suffered in the U.S. S&L crisis of the 1980s and early 1990s.

As Arthur J. Rolnick notes, an important lesson of the S&L episode is: "Despite a host of regulatory agencies and well-intentioned bank regulators, the regulatory system failed to contain the moral hazard induced by 100 percent deposit insurance. . . . While ways may be found to improve the regulatory system, they are all likely to fail without the aid of market discipline."[63] Archer-Shaw protects personal accounts from losses but allows gains only through highly risky investments. That lack of true market discipline creates a moral hazard problem every bit as acute as that of the S&L industry.

The presence of moral hazard in Archer-Shaw transforms an approach that is less than perfect to one that is unacceptably risky.

Notes

1. The U.S. General Accounting Office estimated that the direct and indirect costs of the S&L crisis totaled $160.1 billion, $132.1 billion of which was paid by taxpayers. Those cost estimates exclude interest costs associated with financing the bailout. Interest costs of Financing Corporation and Resolution Funding Corporation bonds are estimated at $111.8 billion, $76.2 billion of which was paid by taxpayers. In addition, the GAO calculated the interest costs derived from direct appropriations at $209 billion (since those appropriations required additional deficit spending). Of that amount, $176 billion remains to be paid. In sum, the GAO estimates that the total cost—past and future—of the S&L crisis to the public and the private sector exceeds $480 billion. See U.S. General Accounting Office, *Financial Audit: Resolution Trust Corporation's 1995 and 1994 Financial Statements* (Washington: Government Printing Office, July 1996), pp. 13, 19.

2. At this writing, the Archer-Shaw proposal has not been entered as legislative language. Analysis herein relies on material produced by Reps. Archer and Shaw and the House Ways and Means Committee.

3. Graham Bannock, R. E. Baxter, and Evan Davis, *The Penguin Dictionary of Economics*, 5th ed. (London: Penguin Books, 1992), p. 295.

4. An early application of moral hazard principles to broader public policy was Sam Peltzman, "The Effects of Automobile Safety Regulation," *Journal of Political Economy*, August 1975, pp. 677–725.

5. See Joe Stilwell, "The Savings and Loan Industry: Averting Collapse," Cato Institute Policy Analysis no. 7, February 15, 1982.

6. The United States has a "dual banking system." Financial institutions such as S&Ls can be chartered and regulated either by the federal government or by the state in which they are based.

7. The major federal legislation was the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn–St. Germain Depository Institutions Act of 1982. Comparable state legislation gave similar powers to many state-regulated thrifts.

8. The 1989 Financial Institutions Reform, Recovery and Enforcement Act discontinued this regulatory goodwill, forcing the S&Ls to quickly recognize their losses by either reducing their asset holdings by selling loans or raising capital from investors. Some weaker institutions were forced into insolvency. In 1996 the U.S. Supreme Court ruled in *United States v. Winstar Corp.* that the government had breached contracts with the thrifts. More than 100 are currently pursuing claims, at an estimated cost to taxpayers of from $10 billion to $20 billion.

9. In practice, even the $100,000 limit could be evaded through the practice of "brokering deposits," in which an individual with large sums of money would contract with a third party to open accounts in multiple institutions. Many S&Ls were flooded with brokered deposits, which led to declines in the quality of the S&Ls' loans. Deposit brokering was limited through provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991.

10. Quoted in "Beware of Moral Hazard," Editorial, *Thomson's International Banking Regulator*, February 27, 1995, p. 4.

11. One effect of lower capital requirements was that even relatively small investment failures could push an institution into insolvency, thereby transferring losses to the deposit insurance system.

12. National Commission on Financial Institution Reform, Recovery and Enforcement, *Origins and Causes of the S&L Debacle: A Blueprint for Reform* (Washington: Government Printing Office, July 1993), p. 46.

13. Quoted in Jonathan Lanser, "What We Learned from Keating," *Orange County Register*, April 11, 1999, p. K1.

14. See Arthur J. Rolnick, "Market Discipline as a Regulator of Bank Risk," Federal Reserve Bank of Boston Conference Series no. 37, November 1993. The cost of bank closures from 1930 to 1935 totaled $6.7 billion ($81.4 billion in 2000 dollars), according to the Federal Deposit Insurance Corporation. Estimates of the total cost of the S&L crisis run as high as five times that amount.

15. National Commission on Financial Institution Reform, Recovery and Enforcement, p. 71.

16. Bert Ely, "How Washington Spawned the S&L Crisis," Editorial, *San Diego Union-Tribune*, September 9, 1990, p. C4.

17. Quoted in Marianne Lavell, "Commission Says: Abolish Thrifts," *National Law Journal*, August 16, 1993, p. 3.

18. See *1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Trust Funds* (Washington: Government Printing Office, 1999), Table III.A2, "Comparison of Estimated Income Rates and Cost Rates for

OASDI and HI, Calendar Years 1999–2075, Intermediate Assumptions."

19. William Jefferson Clinton, "Remarks at White House Conference on Social Security, April 7, 1998," www.whitehouse.gov/wh/work/040798.

20. William Jefferson Clinton, "Remarks at Albuquerque, New Mexico, July 20, 1998," quoted in Michael Tanner, "The Perils of Government Investing," Cato Briefing Paper no. 43, December 1, 1999, p. 1.

21. Alan Greenspan, Testimony before the Senate Committee on the Budget, 106th Cong., 1st sess., January 28, 1999.

22. On the dangers of government investment of payroll taxes, see Tanner; and Krzysztof M. Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," Cato Institute Social Security Paper no. 6, January 14, 1997.

23. Senate Amendment 145 to Senate Conference Resolution 20, sponsored by Sen. John Ashcroft (R-Mo.), passed March 24, 1999.

24. Hans Reimer, "Four Arguments against Social Security Privatization," 2030 Center, May 17, 1998, www.ourfuture.org/features/sss/experts. asp.

25. See Melissa Hieger and William Shipman, "Common Objections to a Market-Based Social Security System: A Response," Cato Institute Social Security Paper no. 10, July 22, 1997. See also Jeremy Siegel, *Stocks for the Long Run,* 2d ed. (New York: McGraw-Hill, 1994), chap. 1.

26. For instance, in 2035 Social Security is projected to take in 13.2 percent of wages while promising benefits equal to 18.2 percent of wages, a shortfall of 5 percent of wages. Under this hypothetical reform plan, tax revenues in 2035 would be reduced to 11.2 percent of wages while benefits would fall to 16.2 percent, but the funding shortfall of 5 percent of wages would remain unchanged. Taxes would still have to be raised or benefits cut.

27. Bill Archer and Clay Shaw, Testimony before the House Budget Committee Task Force on Social Security, 106th Cong., 1st sess., June 29, 1999.

28. Bill Archer, "Statement on Introduction of Social Security Guarantee Plan, April 28, 1999," www.house.gov/archer/issues/socialsecurity/index/html.

29. Instead of being deducted from workers' payroll taxes (a "carve-out"), those deposits would be funded out of projected budget surpluses (an "add-on"). See Darcy Ann Olsen, "Social Security Reform Proposals: USAs, Clawbacks, and Other Add-Ons," Cato Briefing Paper no. 47, June 11, 1999.

30. Archer and Shaw use the phrase "investment options," which I have taken to mean discrete funds rather than fund companies offering a variety of investment products. The number of options, be they funds or fund companies, is less important than how they would be approved or regulated.

31. Bill Archer and Clay Shaw, "Outline of the Social Security Guarantee Plan," April 28, 1999, www.house.gov/archer/issues/socialsecurity//index/html.

32. An annuity is an insurance contract between an individual (the annuitant) and an insurance company guaranteeing regular periodic payments for a specified period of time in exchange for a prior payment to the insurance company. In other words, an annuity is a way to convert a lump sum of money (the premium) into a defined regular benefit continuing for an agreed-upon period of time, often the lifetime of the purchaser.

33. Archer, "Statement on Introduction of Social Security Guarantee Plan"; and Archer and Shaw, Testimony of June 29, 1999.

34. Bill Archer, "President's Social Security 'Plan' Still Won't Save Social Security Program," Press release, October 21, 1999.

35. The new benefit statement is available at www.ssa.gov.

36. If purchased at age 65. Annuity prices from Olivia Mitchell, James M. Poterba, and Mark J. Warshawsky, "New Evidence on the Money's Worth of Individual Annuities," National Bureau of Economic Research Working Paper no. 6002, April 1997, Table 1, p. 34.

37. Bear in mind that Social Security benefits are indexed for inflation, while the typical annuity is not. Inflation-adjusted annuities have only recently entered the market. To ensure a monthly income equivalent to Social Security later in life, a worker would have to purchase a larger nonindexed annuity. That would increase the bonus return needed.

38. Siegel, pp. 13, 15.

39. Ibid., p. 27. Even if Wanda Worker were younger, with more time to save, the needed bonus return would remain high. If Wanda were

25, with 42 years to add to her account, she would need a real annual return averaging 9 percent to receive extra benefits. Even this return is very unlikely on standard stock index funds. Assuming an average market return of 7 percent, a standard deviation of returns of 2 percentage points (the deviation for 30-year holdings), and a normal distribution of returns, only one account in six would bring extra benefits. The standard deviation of returns over 42 years would be smaller than over 30 years, so the percentage of workers achieving the bonus return would be even lower.

40. Daniel J. Mitchell, "GOP Offers a Social Security Plan Worse Than Clinton's," *Wall Street Journal,* May 3, 1999, p. A22.

41. Archer and Shaw, Testimony of June 29, 1999. Emphasis added.

42. Oath of the National Association of Personal Financial Advisers, www.napfa.org.

43. Memorandum from Stephen C. Goss, deputy chief actuary, Social Security Administration, to Henry C. Ballantyne, chief actuary, Social Security Administration, April 29, 1999, www.house.gov/archer/issues/socialsecurity/index/html.

44. Assuming the remaining 80 percent of accounts returned an average of 5.6 percent annually.

45. Quoted in Lavell, p. 3.

46. Even under normal circumstances, a mixed portfolio could fail to control risk. Since bonds are more volatile than stocks over the long run, adding a bond index fund to the portfolio would tend to increase risk unless the bond portfolio was intentionally designed with a negative covariance of returns to the stock portfolio (meaning that when the stocks performed above average the bonds would perform below average, and vice versa). See Siegel, pp. 26–29.

47. Archer, "Draft summary of the Social Security Guarantee Act of 2000," attachment to "President Throws in the Towel on Saving Social Security," Press release, January 26, 2000.

48. "The Potomac Funds Announce Launch of the Potomac Dow 30 Plus Fund and the Potomac Internet Plus Fund," Company press release, White Plains, N.Y., December 1, 1999.

49. Archer, "Statement on Introduction of Social Security Guarantee Plan." Emphasis added.

50. On fiduciary responsibility, see Employee Retirement Income Security Act, 29 U.S.C. § 1104 (1974).

51. ERISA, § 1104(a)(1)(B). Even under a strict interpretation of prudence, risky investments might be permissible: the law's requirement is to diversify *"the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so."* ERISA, § 1104(a)(1)(C). Emphasis added. Under Archer-Shaw, clearly it would not be prudent to diversify so as to minimize the risk of large losses since doing so would minimize the prospect for large gains.

52. That would not be unprecedented. In the privatized Chilean system, minimum and maximum annual returns relative to market averages are dictated by the government; that has had the effect of forcing fund providers to create essentially identical investment products. This could lead to capital misallocation, since funds would not necessarily flow where returns were highest. In addition, it concentrates the interests of workers, as well as the voting power of shareholders, in a relatively few industries. See L. Jacobo Rodríguez, "Chile's Private Pension System at 18: Its Current State and Future Challenges," Cato Institute Social Security Paper no. 17, July 30, 1999, pp. 5, 8–9.

53. Archer-Shaw's Social Security Guarantee Board would consist of six individuals appointed by the Social Security Board of Trustees, who are themselves appointed by the president. (Four of the Social Security trustees are appointed automatically: the secretaries of the Treasury, Labor, and Health and Human Services and the commissioner of Social Security. Two outside trustees are appointed by the president and confirmed by the Senate.) Could members of the new board alter the definition of "low-risk" to encompass nonmarket risks such as those posed by the environment, local economic conditions, labor relations, and social justice? For instance, former labor secretary Robert Reich, a noted enthusiast for "industrial policy" under which the government favors industries it believes to be important to future economic growth, was a member of the Social Security Board of Trustees during his tenure in the Clinton cabinet. Would his appointment to an Archer-Shaw guarantee board be entirely divorced from his economic views? Likewise, in his environmental manifesto, *Earth in the Balance,* Vice President Gore says that protecting the environment should be the "central organizing principle of our civilization." To Gore, this "means embarking on an all-out effort to use every policy and program, every law and institution, every treaty and alliance, every tactic and strategy, every plan and course of action to halt the destruction of the environment." Al Gore, *Earth in the Balance* (New York: Plume, 1993), pp. 272, 274. As Patrick J. Michaels, senior fellow in environmental studies at the Cato Institute, commented, "If writing a bill to invest Social Security funds in the stock market isn't a 'policy,' a 'pro-

gram,' a 'law' applied to an 'institution,' a 'tactic,' and/or a 'strategy,' I don't know what it is." Patrick J. Michaels, "Social Security or Green Socialism?" *Washington Times*, March 5, 1999, p. A17.

54. See Archer and Shaw, Testimony of June 29, 1999; and Goss.

55. See Archer and Shaw, Testimony of June 29, 1999.

56. Joseph J. Cordes and C. Eugene Steuerle, "A Primer on Privatization," Urban Institute, Retirement Project, Occasional Paper no. 3, November 1999, p. 12.

57. On other flaws in Archer-Shaw, see Olsen, pp. 9–10.

58. Martin Feldstein, "America's Golden Opportunity," *The Economist*, March 13, 1999, pp. 41–43.

59. Joel Mowbray, "The Flaws in Feldstein," *Investors' Business Daily*, April 23, 1999, p. A24.

60. "Wanda Worker" was born in 1960 and earns $30,364 annually. Assuming her income continues unchanged, at age 67 she would be entitled to Social Security benefits of $1,096 per month, equivalent to a private joint-and-survivor annuity costing $169,136 (at average 1995 prices). If personal accounts were funded with the 10.6 percent of wages currently devoted to Social Security's Old Age and Survivors program, Wanda would invest $268.22 in her account monthly. Over a 45-year working lifetime, an annual return of 0.67 percent would be sufficient to fund guaranteed monthly retirement benefits of $1,096. If, like many women, Wanda purchased a single annuity rather than a more expensive joint-and-survivor annuity, her annuity cost would fall to only $138,035 at retirement and her required rate of return to less than zero (i.e., her investments could lose money and she would still be better off than she would be with Social Security). Finally, even if Wanda spent 10 years raising children (meaning she had a working lifetime of only 35 years), with an annual return of only 2.2 percent she could still save enough to purchase a joint-and-survivor annuity.

61. In Feldstein's plan, the shortfall is made up by increasing the size of the initial account, funded out of general revenue. Although Social Security reaps a smaller percentage of the account's balance under Feldstein's plan than under Archer-Shaw, the larger initial account balance reduces the funding gap caused by Feldstein's 75 percent clawback.

62. Archer, "Statement on Introduction of Social Security Guarantee Plan." Emphasis in original. For discussion of how to fund a full privatization plan without raising taxes or cutting benefits, see Peter J. Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998), esp. chap. 9.

63. Rolnick, p. 7.

Published by the Cato Institute, Cato Briefing Papers is a regular series evaluating government policies and offering proposals for reform. Nothing in Cato Briefing Papers should be construed as necessarily reflecting the views of the Cato Institute or as an attempt to aid or hinder the passage of any bill before Congress. Additional copies of Cato Briefing Papers are $2.00 each ($1.00 in bulk). To order, or for a complete listing of available studies, write the Cato Institute, 1000 Massachusetts Avenue, N.W., Washington, D.C. 20001, call (202) 842-0200 or fax (202) 842-3490. Contact the Cato Institute for reprint permission.