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No Second Best
The Unappetizing Alternatives to Social Security Privatization

by Michael Tanner

Executive Summary

Although proposals for privatizing Social Security have been much debated, there has been far less discussion of the alternatives. Indeed, most opponents of privatization would prefer to avoid comparing various proposals for reform. That is probably because their alternatives boil down to some very unpopular options—raising taxes, cutting benefits, or government investment in the stock market.

Not surprisingly, the alternative most frequently suggested by opponents of privatization is to increase taxes, either directly or indirectly. Suggested tax changes range from increases in payroll tax rates or the base income on which payroll taxes are collected to the use of general revenues and, particularly, repeal of the income tax cuts that passed Congress in 2001. Other tax changes proposed include increasing capital gains taxes, taxing all stock transactions, increasing taxes on Social Security benefits, and requiring newly hired state and municipal workers to participate in Social Security.

Opponents of privatization are also willing to consider significant cuts in Social Security benefits. Many would increase the computation period used to calculate benefits—a proposal that would be particularly harmful to women and minorities—and raise the retirement age, which would particularly affect lower-income and minority workers, who have shorter life expectancies. Others would reduce spousal benefits or trim increases in cost-of-living allowances.

Finally, many opponents of individual accounts would allow the federal government to directly invest Social Security funds in private capital markets. That approach risks politicizing the investment process and undermining our free-market economic system.

Allowing workers to privately invest Social Security taxes makes sense on its own. It gives workers ownership of and control over their money, increases rates of return, allows low-income workers to accumulate wealth, and moves the system toward fiscal balance. Compared with the alternatives, privatization looks even better.

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Opponents of privatization offer few concrete proposals.

Introduction

While proposals for privatizing Social Security have been much debated, there has been far less discussion of the alternatives. Indeed, opponents of privatization often critique privatization proposals as if those proposals existed in a vacuum. They compare privatization proposals with "current law" and suggest that those proposals will provide lower benefits, or at least lower government-provided benefits. Or they suggest that the costs of transition to a privatized system will require tax increases.

But as Charles Blahous, executive director of the President's Commission to Strengthen Social Security, has pointed out, "The essential problem with comparing reform plans with 'current law' is that 'current law' allows the system to go bankrupt."[1]

Impending bankruptcy is not the only problem facing Social Security. Payroll taxes are already so high that younger workers will receive an extraordinarily poor rate of return. In addition, Social Security contains a host of inequities that penalize working women, minorities, and low-income workers.

Most critics of privatization focus only on insolvency. They implicitly assume that the structure of the current program is fine and the changes needed are only in the program's financing. Therefore, the solutions they offer generally do not deal with establishing property rights, making benefits fairer to women or minorities, allowing low-wage workers to accumulate wealth, or even increasing rates of return.

Yet, even judging by their own limited standards, opponents of privatization offer few concrete proposals.

President Clinton identified the limited range of options available to restore Social Security to solvency: raise taxes, cut benefits, or get a higher rate of return through investment in real capital assets.[2] Henry Aaron, a noted opponent of privatization at the Brookings Institution, agrees. "Increased funding to raise pension reserves is possible only with some combination of additional tax revenues, reduced benefits, or increased investment returns from investing in higher yielding assets," he told Congress in 1999.[3]

The question, then, is, since opponents of privatization have rejected individual investment to earn a higher rate of return, which of the other alternatives do they support—raising taxes? cutting benefits? or some nonindividual form of investment?

As Reps. Jim Kolbe (R-Ariz.) and Charles Stenholm (D-Tex.) have pointed out in a recent letter to the bipartisan congressional leadership, "All participants in the debate over the future of Social Security must be held to the same standard so that the different approaches to strengthening Social Security can be compared on a level playing field."[4]

Unfortunately, few if any opponents of privatization have put an actual scoreable proposal on the table. Indeed, the President's Commission to Strengthen Social Security specifically invited opponents of privatization to submit detailed proposals for reforming the system, offering to have those proposals scored by the Social Security Administration on the same basis as the commission's own proposals. However, no opposition group chose to take advantage of the offer.[5]

Still, from their writing, testimony, and speeches, it is possible to piece together what opponents of individual accounts offer as an alternative. Generally, those proposals boil down to some pretty unpopular alternatives—tax increases, benefit cuts, or government investing.

All of those proposals contain significant costs and risks for both individuals and the American economy.

Tax Increases, Explicit and Otherwise

Not surprisingly, since their primary goal is to preserve the structure and benefits of the current system, the solution most commonly offered by opponents of privatization is some form of tax increase. The National Academy on an Aging Society suggests that there is no limit to the amount of taxes American society can bear if they are used for a good cause such as preserving Social Security. The academy specifically rejects the notion, widely accepted by economists, that total taxes should not exceed 20 percent of national income. "Perhaps the question for the public has more to do with what government is doing with taxes, than the relative size of government."[6]

Joseph White, a fellow with the Century Foundation and professor of public policy at Case Western University, takes a similar approach. In his book *False Alarm: Why the Greatest Threat to Social Security and Medicare Is the Campaign to "Save" Them,* White argues:

> We have a responsibility to maintain a decent society. Social Security and Medicare are part of that. We have a responsibility not to confuse solving the government's problems (by cutting its expenditures) with solving society's. No matter where we started, cutting Social Security and Medicare would be good for the budget. Eliminating them would be better. But the government does not exist just for its budget. The government exists to make the country a better place to live. Social Security and Medicare do make this a better country, and they can and should be preserved from the attack on entitlements.[7]

Ken Apfel, social security commissioner under President Clinton, says that successful Social Security reform will require us to abandon the notion that "future tax revenues should not be increased—even modestly." Apfel warns that "over the next several decades Social Security taxes are projected to decline by more than 10 percent as a percentage of GDP. With a doubling of the senior population, more revenue will be needed, not less."[8]

Lisa Maatz, formerly of the Older Women's League, argues that, "while not a favorite of most taxpayers, [tax increases have] a place in the solvency discussion. If it helps preserve the universal nature of Social Security, where no individual is left to sink or swim on their own, it may be worth the cost."[9]

This is ultimately the point, an admittedly philosophical one, of those who would raise taxes to preserve Social Security. They see Social Security as a good thing, and, therefore, in their view, we should be willing to pay whatever it takes to preserve the program in its current form.

The first place to look for tax increases is the payroll tax itself. For example, Vincent Sombrotto, president of the National Association of Letter Carriers, has urged the president's commission to "reject the notion that taxes can never be raised to overcome the projected shortfalls in the Social Security Trust Fund. If Americans are living longer, why shouldn't we pay higher payroll taxes to handle it?"[10] Likewise, former social security commissioner Robert M. Ball, writing for the Century Foundation, proposes "moderately" increasing future payroll taxes.[11] Jeff Faux of the Economic Policy Institute would not only raise payroll taxes but would index them to future increases in longevity.[12] Various levels of payroll tax increases are also supported by Notre Dame economist Teresa Ghilarducci;[13] Mark Weisbrot of the Center on Economic and Policy Research;[14] and Robert Myers, former chief actuary at the Social Security Administration, who suggests that they would not be "too terribly painful."[15]

As Table 1 illustrates, the tax increase needed to restore Social Security to solvency is extremely large. To maintain benefits after the system begins running a deficit in 2016, the government must acquire new funds equivalent to $103 per worker. By 2030 the tax burden increases to $1,543 per worker, and it continues to rise thereafter.

The tax increase needed to restore Social Security to solvency is extremely large.

Tax increases of this magnitude would have a serious impact on the U.S. economy. A look at the impact of the last rounds of payroll tax hikes shows how increasing payroll taxes can destroy jobs and reduce economic growth. For example, according to the Congressional Budget Office, payroll tax hikes between 1979 and 1982 resulted in the permanent loss of 500,000 jobs.[16] A study of the 1988 and 1990 payroll tax hikes, by economists Gary and Aldona Robbins, estimated 510,000 jobs lost permanently and a reduction of the U.S gross domestic product of $30 billion per year.[17] The reason for this is that workers view payroll taxes as a "pure tax," not as an investment. Higher payroll taxes create a "wedge" between what employers are able to pay and what employees are willing to accept, thereby lowering take-home wages and making employment less attractive.

Projecting the potential impact of future tax increases is more difficult, but the CBO estimates that a 5 percent increase in payroll taxes would reduce marginal after-tax compensation by 10 percent. The CBO further concludes that every 10 percent drop in after-tax wages will lead to as much as a 3 percent contraction in the labor supply. This would, in turn, likely lead to an unspecified, but significant, decline in U.S. GDP.[18]

Table 1
Tax Increases Required to Preserve Social Security's Solvency

Year	Taxes per Worker ($)	Year	Taxes per Worker ($)
2016	103.47	2027	1,312.07
2017	218.12	2028	1,397.35
2018	336.69	2029	1,474.08
2019	457.54	2030	1,543.04
2020	579.91	2031	1,606.49
2021	693.64	2032	1,665.68
2022	806.28	2033	1,715.58
2023	914.51	2034	1,753.08
2024	1,019.93	2035	1,781.23
2025	1,121.66	2036	1,803.52
2026	1,218.52	2037	1,821.61

Source: Author's calculations derived from data in Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *2000 Annual Report* (Washington: Government Printing Office, 2001), Tables VI.E8, VI.E10, VI.B2.

Any change in the payroll tax cap would be a significant tax increase.

Moreover, a payroll tax hike would fall heaviest on low-income workers, who are least able to afford it. According to Jagadeesh Gokhale, a senior economic adviser with the Federal Reserve Bank of Cleveland, increasing the payroll tax would result in a 3.8 percent increase in Social Security's lifetime net tax rate for workers in the lowest quintile of income.[19]

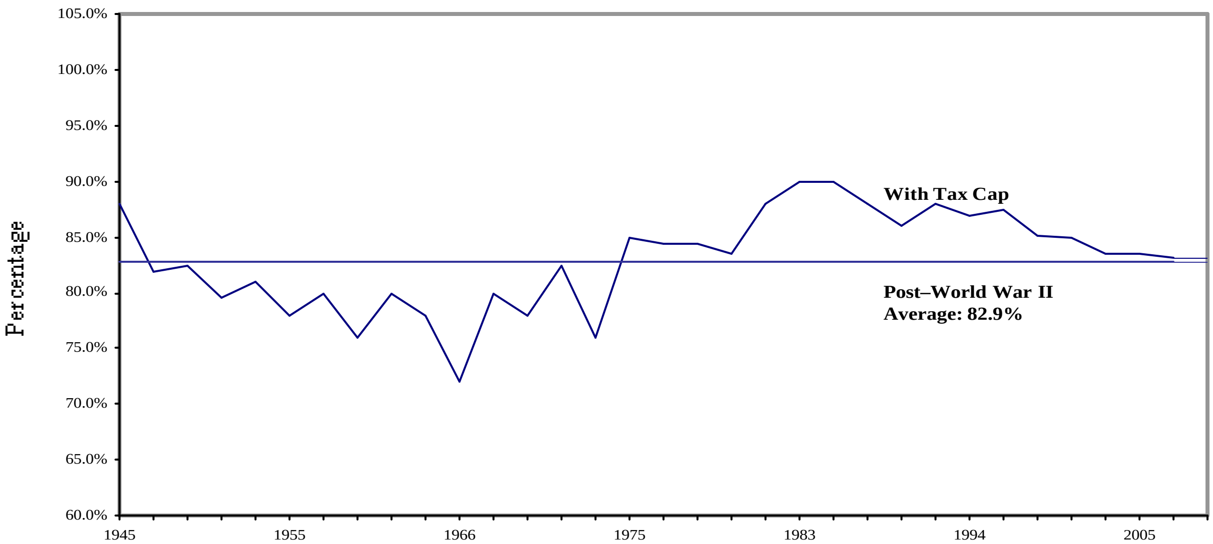
As an alternative to across-the-board payroll tax hikes, some people have suggested targeting the tax increase to upper-income workers by removing the current cap on income subject to the tax. Currently, workers pay Social Security taxes on the first $80,400 of wage income. Income above that level is exempt from Social Security taxes (though not Medicare payroll taxes). Approximately 84 percent of all wage income earned in the United States falls under that cap and is subject to the tax.

It is unclear whether advocates of this approach would remove the cap altogether or simply raise it. The National Committee to Preserve Social Security and Medicare, for example, suggests that the cap be raised so that 90 percent of covered earnings are subject to the tax,[20] as does the AFL-CIO.[21] Hans Reimer of the 2030 Center appears to advocate total repeal of the cap,[22] as do the National Council of Women's Organizations[23] and the Older Women's League.[24] Dean Baker of the Center for Economic and Policy Research would remove the cap as well, but only on the employer's portion of the payroll tax.[25] Ball would raise the cap, but only to 87.5 percent of covered earnings.[26]

Advocates of raising or eliminating the cap on payroll taxes often suggest that the current level of covered wages is significantly below the roughly 90 percent of earnings subject to the tax in 1983, at the time of the Greenspan Commission's reform. What they fail to note, however, is that the 1983 rate was unnaturally high. In fact, as Figure 1 shows, from 1945 to 1965, the proportion of wages covered by the payroll tax declined steadily from 88 percent to roughly 71 percent. However, beginning in 1965, in order to pay for increased benefits, the cap was gradually increased, reaching a high of 90 percent in 1983. Since that time, it has again begun to decline, but it remains above the post–World War II average of 82.9 percent.[27]

The multiplicity of proposals and their vagueness make it difficult to analyze their impact. However, there is no doubt that any change in the payroll tax cap would be a significant tax increase. In fact, total elimination of the cap would amount to the largest tax increase in U.S. history, $461 billion over the first five years.[28] For workers with wages over the cap, it would amount to an immediate 12.4 percent increase in their marginal tax rates, such that many workers would be paying more than half

Figure 1
Percentage of Wages Subject to Old-Age and Survivors Payroll Taxes



Source: D. Mark Wilson, "Removing Social Security's Tax Cap on Wages Would Do More Harm Than Good," Heritage Foundation Center for Data Analysis Report no. 01-07, October 17, 2001.

their income in federal taxes alone.

While the economic consequences of raising or eliminating the payroll tax cap would be less than those of an across-the-board tax hike, they would still be considerable. The Heritage Foundation estimates that removing the cap would reduce the rate of U.S. economic growth by 2–3 percent. Over the next 10 years it would cost the U.S. economy nearly $136 billion in lost growth. In addition, roughly 1.1 million jobs would be lost over the next 10 years.[29]

However, in exchange for this massive tax increase and its attendant costs, Social Security would gain very little. Even total repeal of the cap would extend the payroll tax solvency of Social Security by only an estimated seven years.[30]

Less direct tax increases are also contained in proposals to redirect general tax revenue to Social Security. The result would be to rely, not on payroll tax hikes, but on increases in income or other taxes to make up for any gap in Social Security's financing.[31]

Of course, tax increases are not necessary to support general revenue financing of Social Security. The federal government could always reduce other spending and devote the savings to Social Security. Indeed, advocates of Social Security privatization have suggested that as a way to help finance the transition to a system of individual accounts.[32] However, such spending reductions would be considerable, and most opponents of privatization are not advocates of cutting government spending. In fact, their statements and publications show that they are talking about an increase in income tax revenue.

Instead of advocating new taxes, one common approach calls for repeal of the tax reductions that passed Congress in 2001 but have not yet taken effect. However, one suspects that this position stems more from opposition to the tax cut than from concern about Social Security. The tax cuts, after all, expire by 2009, meaning that Social Security will be running a surplus throughout the period during which the tax cuts are in effect. Social Security's deficit doesn't start until approximately 2016. Presumably, then, when advocates of repealing the tax cut speak of applying the funds to Social Security, they mean somehow crediting the money to the Social Security Trust Fund.

Even total repeal of the cap would extend the payroll tax solvency of Social Security by only an estimated seven years.

All of those proposals reflect a fundamental misunderstanding of the nature of the trust fund. Social Security payroll taxes are currently bringing in more revenue than the program pays out in benefits, a surplus that is projected to continue until approximately 2016. Thereafter, the situation will reverse, with Social Security paying out more in benefits than it brings in through taxes. The surplus is used to purchase special issue Treasury bonds. The Social Security surplus used to purchase the bonds becomes general revenue and is spent on the government's annual general operating expenses. What remains behind in the trust fund is the bonds, plus an interest payment attributed to the bonds (also paid in bonds, rather than cash). Government bonds are, in essence, a form of IOU. They are a promise against future tax revenue. When the bonds become due, the government will have to repay them out of general revenue.[33]

Adding more money to the trust fund now would simply increase the number of bonds. The money from purchase of those bonds would revert to general revenue and be spent. It is an endless cycle that does nothing to change Social Security's actual solvency.

That is why the more sophisticated proponents of tax increase would not actually apply the increased revenue to Social Security but to paying down the national debt. As Robert Shapiro, former under secretary of commerce in the Clinton administration explains, "Getting rid of the debt will save hundreds of billions of dollars a year in interest payments, significantly pushing back the day of reckoning on redeeming those trust fund assets. . . . If the next generation decides to borrow to redeem those assets, becoming debt-free first will make it a lot cheaper to do so."[34]

In short, paying down the debt will save money currently spent on interest payments. Presumably, this will provide extra revenue to pay benefits after 2016. Moreover, if it becomes necessary to borrow in order to cover Social Security's post-2016 shortfall, it will be easier to do so if the current national debt has been paid off. There is a kernel of truth to both these points. But eventually both fall short.

Despite budget shortfalls caused by the slowing economy after the terrorist attacks of September 11 and increased government spending, the Bush administration still projects future non–Social Security surpluses, much of which would be dedicated to paying down the national debt. It is true, of course, that repaying government debt reduces the interest payments the government must pay each year. These savings in debt service costs could, in theory, assist in maintaining the solvency of the Social Security system. But the extent of the help should not be overestimated. In 2000 the government paid approximately $225 billion to service the publicly held debt. If that debt were repaid (or had never been run up in the first place), the government would have, in theory, an extra $225 billion annually with which it could increase spending or reduce taxes.

But how far would those interest savings take Social Security? Assume that the publicly held debt is retired by 2016, the year in which Social Security begins to run payroll tax deficits, thereby adding an extra $225 billion annually to Social Security's balance sheets. While this would help, it would take only until 2021 for Social Security to run payroll tax deficits exceeding $225 billion. In other words, those debt service savings would buy Social Security another five years of payroll tax solvency.

The larger case for debt repayment, however, isn't based on reducing debt service costs or increasing the government's capacity to borrow. It is that repaying debt frees investment dollars that were previously used to finance government operations so those dollars can be dedicated to more productive, private investment. Retiring government debt injects capital into the economy; more capital means better tools and technology for each worker, which raises worker wages and increases the nation's productivity. A more productive economy is better able to support larger populations of retirees with a relatively smaller supply of workers. The economics of debt repayment are relatively simple; the politics, which determines whether debt is retired, how much is retired, and how the benefits of a reduced debt burden are allotted, is substantially more complicated.[35]

Roger Hickey, director of the Campaign for America's Future, while strongly advocating repeal of the Bush tax cut, seems to acknowledge that repeal will have little direct impact on Social Security, since he does not even pretend to advocate applying the new revenue to the Social Security system. Nor would he use the new revenue to pay down the debt. Rather, he would increase government spending generally in the belief that increased government spend-

Table 2
Results of Repealing Tax Cut and Reducing Cap on Payroll Taxes

Income ($)	Tax Rate after Bush Cuts (%)	Payroll Tax (%)	Total Tax (%)	Tax Rate if Tax Cuts Repealed (%)	Payroll Tax if Cap Removed (%)	Total Tax with Increases (%)
0–27,050	10.0	15.3	25.3	15.0	15.3	30.3
27,050–65,550	15.0	15.3	30.3	28.0	15.3	43.3
65,550–84,900	25.0	15.3	40.3	31.0	15.3	46.3
84,900–136,750	25.0	2.9	27.9	31.0	15.3	46.3
136,750–297,350	33.0	2.9	35.9	36.0	15.3	51.3
Over 297,350	39.6	2.9	42.5	39.6	15.3	54.9

ing would lead to increased economic growth, making additional revenues available in the future.[36] Hickey's Social Security plan, therefore, amounts simply to a dose of old-fashioned "tax and spend" economics.

These tax increases would not be without consequences. Interestingly, many of the people advocating repeal of the Bush tax cuts also favor reducing the cap on payroll taxes. The combined result of the two actions would be an astounding increase of more than 15 percent in top marginal tax rates (Table 2). But most economists would agree that high marginal tax rates are very likely to restrict economic output and, potentially, economic growth.[37]

Some opponents of privatization go beyond repealing the Bush tax cut and advocate other forms of general tax increases. For example, several opponents of privatization have suggested increasing the tax on Social Security benefits. Communitarian author and commentator Amitai Etzioni, for example, would extend income taxes to all Social Security benefits, ignoring the fact that the employee's portion of the payroll tax has already been taxed.[38] (Social Security taxes are not deducted from gross income for income tax purposes.) Less drastically, the AFL-CIO[39] and Aaron[40] would tax Social Security in the same way as other pension income.

Going still further on the tax front, Baker calls for a tax on all stock transactions. Both the buyer and the seller of stocks would be taxed at 0.25 percent of the transaction price.[41] Baker would also increase the capital gains tax from its current 18 percent to 28 percent, the rate prior to 1997.[42]

To the degree that these tax increases bring in revenue before 2016, they suffer from the same problems as does repealing the Bush tax cut. However, presumably they would also increase revenues after 2016, which would allow revenues to be used to pay Social Security benefits.

There is one final revenue-raising proposal that appears to be gaining support among some opponents of privatization. Currently, some 5 million state, county, and municipal workers do not participate in the Social Security system. Instead, they participate in their own retirement programs, which provide far better benefits than does Social Security.[43] However, the National Committee to Preserve Social Security and Medicare would require all newly hired public employees to be brought into the Social Security system,[44] as would Aaron.[45] This would be a 12.4 percent tax hike for those workers and could potentially force them to curtail contributions to their far more lucrative private pension plans.

Some opponents of privatization would require all newly hired public employees to be brought into the Social Security system.

Benefit Cuts

The flip side of tax hikes is benefit cuts. Most opponents of privatization have been reluctant to propose any reduction in currently promised Social Security benefits. After all, their goal is to preserve the current benefit structure. Still, a few have put benefit cuts on the table.

Many of the cuts proposed by opponents of privatization sound very much like the cuts they warn would result from privatization.

In fact, Baker suggests that benefit cuts might not be such a bad thing. He points out that, because of scheduled increases in the benefits baseline, even after required cuts, retirees would receive checks for higher dollar amounts than they do today.[46] Baker is not necessarily incorrect in this. Indeed, the President's Social Security Commission makes a similar argument.[47] However, it does render rather hypocritical the argument of opponents of privatization that reductions in government-provided benefits included in some privatization plans are automatically bad.

Indeed, many of the cuts proposed by opponents of privatization sound very much like the cuts they warn would result from privatization. For example, one of the most widely criticized proposals by the president's commission was a plan to change the indexing formula used to determine benefits. The formula is now adjusted for wage productivity; the change would be to adjust it for prices. Benefits would remain constant on an inflation-adjusted basis but would no longer increase at a rate greater than that of inflation. Opponents of privatization, including Aaron and colleagues, called this a deep cut in benefits.[48] But in 1976 Aaron supported a very similar proposal by a congressional commission, which included such anti-privatization stalwarts as MIT professor Peter Diamond, who said that it "would leave more options open for spending the productivity dividend of economic growth. Congress could still raise pensions in the future, but it could also decide that other programs such as housing, health insurance, or defense have greater claims on available funds."[49]

The same holds true for other proposed cuts. Shapiro, while joining the chorus calling for repeal of the Bush tax cuts, also suggests increasing the retirement age and reducing cost-of-living adjustments.[50] Apfel, while not providing any specific proposals for cuts, suggests that "modest measures should be taken to keep Social Security benefit levels from growing as fast as the economy."[51]

Ball suggests that the increase in benefits for future retirees, scheduled under current law, should be slowed by about 3 percent. He would accomplish that primarily through increasing the benefit computation period from the present law's 35 highest years' wages to 38 years.[52] Alicia Munnell of Boston University would also increase the benefit computation period,[53] as would Aaron. Lengthening the computation period means that more years of low or no wages would be included when determining the average wage on which to base benefits.[54]

In fact, Aaron probably supports the most extensive cuts in benefits of any foe of privatization. For example, while opponents of privatization often accuse its supporters of favoring increases in the retirement age, Aaron would raise not only the normal retirement age but also the early retirement age.[55] He is supported in this approach by fellow Brookings scholar Gary Burtless.[56] Myers would speed up already scheduled increases in the normal retirement age but would leave early retirement untouched. Ghilarducci would also agree to speed the increase in the normal retirement age to 67, but only if disability criteria are loosened to include sector unemployment.[57]

Aaron would consider still further benefit cuts, including reducing or even eliminating spousal benefits.

> The simplest and least costly way to end the lesser earner problem would be to eliminate the spouse's benefit altogether. However, this step would significantly reduce benefits for many older couples in which one spouse worked outside the home little or not at all. It would also make it far more costly for one parent to stay home to care for children. But a large majority of mothers, even those with preschool age children, now work, and that proportion has been rising. To aid parents who stay at home to care for children, Vice President Al Gore proposed, as part of his 2000 campaign for president, to give earnings credits of one half the average wage for up to five years spent caring for young children. Such a provision would further reduce the need for the spouse's benefit. A gradual reduction in the spouse's benefit over a decade or so from one-half of the principal earner's benefit to one-third or even one-quarter would free-up funds that could be used to lower the projected long-tem deficit or applied to improving benefits in other ways.[58]

However, with the exception of his coauthor Robert Reischauer, few opponents of privatization are willing to embrace such significant benefit cuts.

Government Investing

The third alternative identified by President Clinton is to find a way to achieve a higher rate of return on monies paid into the Social Security system. In practice, this means investing Social Security funds in private capital assets. That is precisely the point made by many advocates of Social Security privatization. However, because opponents of privatization reject the idea of allowing workers to invest their Social Security taxes through individual accounts, they are forced to turn to a different entity for investing, namely the government itself.

Supporters of this approach seldom refer to it as government investing; instead, they've devised an impressive collection of euphemisms for the concept. For example, Munnell calls it "broadening the portfolio" of the Social Security Trust Fund.[59] Reimer refers to it as "diversifying the Social Security Trust Fund's investment strategy."[60] To Aaron, it is "improving the management of Social Security's reserves."[61]

Whatever it is called, the concept of government investing is a central part of many reform plans supported by opponents of privatization. Ball proposed such an approach to the Social Security Advisory Council as long ago as 1996. Former president Clinton included it in his proposal for Social Security reform. It is at the heart of the proposal advanced by Aaron and is also supported by the National Committee to Preserve Social Security and Medicare,[62] *New York Times* columnist Paul Krugman, and the Older Women's League,[63] as well as Munnell, Reimer, and others.

Allowing the federal government to purchase stocks would give it the ability to obtain a significant, if not a controlling, interest in virtually every major company in America. Experience has shown that even a 2 or 3 percent block of shares can give an activist shareholder substantial influence over the policies of publicly traded companies.[64] The result could be a government bureaucrat sitting on every corporate board, a prospect that has divided advocates of government investing.

Even if the government avoids directly using its equity ownership to influence corporate governance, there is likely to be an enormous temptation to allow political considerations to influence the types of investments that the government makes. Approximately 42 percent of state, county, and municipal pension systems require that some portion of investment be targeted to projects designed to stimulate the local economy or create jobs. This includes investment in local infrastructure and public works projects as well as investment in in-state businesses and local real estate development.[65] In addition, 23 percent of the pension systems have prohibitions against investment in specific types of companies, including companies that fail to meet the "MacBride Principles" for doing business in Northern Ireland; companies doing business in Libya and other Arab countries; companies that are accused of pollution, unfair labor practices, or failing to meet equal opportunity guidelines; the alcohol, tobacco, and defense industries; and even companies that market infant formula to Third World countries.[66]

In fairness, most advocates of government investing believe that sufficient "firewalls" can be built in to prevent government from politicizing its investment decisions. However, given the dismal history of government investment policies, that seems to be based far more on hope than on experience. As Federal Reserve chairman Alan Greenspan observed: "I don't know of any way that you can essentially insulate government decisionmakers from having access to what will amount to very large investments in American private industry. . . . I have been around long enough to realize that that is just not credible and not possible. Somewhere along the line, that breach will be broken."[67]

Some proponents of government investment don't even pretend to insulate the investment process from politics.

Some proponents of government investment don't even pretend to insulate the investment process from politics. For example, Gerald Shea of the AFL-CIO has suggested that it would be a good thing if the government exercised its new influence over the American economy, claiming that government involvement would "have a good effect on how corporate America operates."[68]

This danger led Greenspan to warn that proposals for government investing "have very far reaching potential dangers for a free American economy and a free American society."[69]

International experience also provides ample warning against allowing the government to direct investment in private capital markets. A recent study by the World Bank found nearly universal politicization of government investment policy, resulting in rates of return well below those earned by private-sector investments. Indeed, in many countries returns on government investment were below what could be earned on ordinary bank deposits.[70]

The Ostrich Approach

Some opponents of privatization would prefer to offer no alternative at all. They simply deny that Social Security is in need of reform. For example, Rep. Jerrold Nadler (D-N.Y.) has called Social Security "a crisis that doesn't exist."[71] Baker and Weisbrot wrote an entire book devoted to the idea that Social Security was "a phony crisis."

Their argument is, essentially, that current projections of Social Security's insolvency are too pessimistic. They contend that, if the economy grows faster than projected, then wages and payroll tax revenue will rise, providing more than enough revenue to keep the program going, without any need to make significant changes.

However, as Cato analyst Andrew Biggs has shown, keeping Social Security solvent would require levels of economic growth unprecedented in American history. Moreover, even if the economy does grow more quickly than projected, Social Security's benefit liabilities and funding shortfalls will rise along with it. In short, even under assumptions vastly more optimistic than can be expected, Social Security remains insolvent.[72]

In fact, a new study by a pair of demographers and economists at the University of California–Berkeley suggests that projections about Social Security's future might not be pessimistic enough! Ronald Lee and Ryan Edwards report that "the chance for a really bad outcome is far higher than commonly expected."[73]

Even under assumptions vastly more optimistic than can be expected, Social Security remains insolvent.

As a result, even most opponents of privatization admit that something must be done to reform Social Security, but they won't tell us what.

Beyond Solvency

While most opponents of privatization offer no proposal to fix Social Security's problems beyond solvency, it is worth noting that at least some of their plans would make those problems worse.

Rate of Return

Payroll taxes are already so high relative to benefits that most young workers will receive an extremely poor rate of return, a return far below that provided by private capital markets. The Social Security Administration estimates that 30-year-old medium-wage workers will receive rates of return ranging from a high of 3.42 percent (for a single-earner couple) to just 1.13 percent (for a single male). Those returns will decline even further in the future.[74]

Raising taxes or reducing benefits, as many opponents of privatization advocate, will simply make the rate of return even worse (at least compared with promised benefits). This is particularly true of proposals to increase the payroll tax. The impact on rates of return of other proposals for tax hikes is less easily measured and falls more unevenly. However, any increase in the revenue going into the system without a corresponding increase in benefits will mean lower returns.

Minorities and Women

The current Social Security system contains a host of inequities, many of which disadvantage minorities and women. For example, because lifetime Social Security benefits are closely linked to longevity, people with shorter life expectancies can expect to receive less in retirement benefits. At every age and every income level, African Americans have shorter life expectancies than do whites. As a result, an African American who has the same lifetime earnings and pays the same payroll taxes as a white person can expect to receive a lower rate of return. This problem is exacerbated by the facts that African Americans are more likely to begin working earlier than whites and that African-American marriages are more likely to end in divorce in less than 10 years. Indeed, no group may be as poorly treated by Social Security as African Americans.[75]

None of the proposals advanced by opponents of privatization would change this unfair situation—and many would make it worse. For example, African Americans, who on average earn lower wages, would be disproportionately affected by proposed increases in the payroll tax. Even worse would be increases in the retirement age supported by Aaron and other foes of privatization.

The current system also penalizes many women, especially women who work outside the home. For instance, under Social Security's "dual entitlement rule" for spousal benefits, the spouse with lower lifetime earnings, nearly always the wife, is eligible to receive either a benefit based on her own earnings or one-half of her spouse's benefits, but not both. Effectively, this means that many women pay Social Security taxes but receive no additional benefits for those taxes. Moreover, the current spousal system may set up situations in which a two-earner couple may actually receive less in benefits than a single-earner couple with the same lifetime earnings.[76]

In addition, the loss of up to 50 percent of a couple's benefits at the husband's death throws every fifth widow into poverty.[77] And current rules for spousal benefits deny benefits to women who were married less than 10 years. Since the average marriage lasts only 7 years, millions of women lose benefits under the current system.[78]

Some women's organizations have proposed changes in the current system to address some of those inequities. For example, they would increase benefits for widows and decrease the number of years of marriage required to qualify for spousal benefits from 10 to 7. They would also give women a $5,000 per year credit for years spent raising children outside the workforce.[79] These proposals would make the current system fairer, but they would also be costly, requiring additional revenue equal to more than 1 percent of payroll.[80]

Aside from women's groups, few opponents of privatization have proposed reforms to eliminate the current system's inequities for women. And, once again, many of their proposals would make the problems worse. Proposals to lengthen the period used to compute Social Security benefits would particularly disadvantage women, since women are far more likely than men to have years with zero or low earnings.

And, of course, Aaron's proposal to drastically reduce spousal benefits would directly affect women.[81]

Wealth Creation

One of the strongest arguments for privatization is that a system of individual accounts would give low-income Americans an opportunity to accumulate wealth. In contrast, the current Social Security system contributes to the growing "wealth gap" in the United States. Because it forces the poor to annuitize their savings, it prevents them from accumulating real wealth and passing that wealth on to future generations.[82]

None of the anti-privatization proposals would directly deal with the wealth creation issue. However, some opponents of privatization have proposed creating individual accounts to supplement the current Social Security system as a way to help the poor accumulate wealth. These would be funded, depending on the proposal, through voluntary individual contributions, general tax revenues, or mandatory payroll tax increases.[83] However, studies show that voluntary "add-on" accounts are unlikely to benefit low-income workers. Low-wage workers simply don't have enough discretionary income to be able to contribute more to their retirement savings, even if the government provides generous matching funds.[84] On the other hand, if the add-on accounts are funded by mandatory contributions, they become simply another tax increase. If that increase is combined with the tax increases needed to keep the current system solvent, the burden on low-income workers could become intolerable.

A Right to Benefits

Under the current Social Security system, workers have no legal right to their retirement benefits.[85] In two important cases, *Helvering v. Davis* and *Flemming v. Nestor,* the U.S. Supreme Court has ruled that Social Security taxes are simply taxes and convey no property or contractual rights to Social Security benefits. As a result, a worker's retirement security is entirely dependent on political decisions made by a president and Congress. Benefits may be reduced or even eliminated at any time and are not directly related to Social Security taxes paid into the system. Therefore, retirees are left totally dependent on the whims of politicians for their retirement income.

None of the proposals advanced by opponents of privatization would change this situation in any way.

Conclusion

Opponents of Social Security privatization have generally preferred to attack proposals for individual accounts without discussing their

If add-on accounts are funded by mandatory contributions, they become simply another tax increase.

own alternatives for reforming Social Security. That is most probably because their alternatives boil down to some very unpopular options—raising taxes, cutting benefits, or government investment in private financial assets.

The debate over Social Security privatization is not over a choice between privatization and a mythological Social Security system that can pay all promised future benefits without any increase in taxes. Individual accounts would win even that debate, since they give workers ownership of and control over their money, increase rates of return and therefore benefit levels, and allow low-income workers to accumulate wealth. The real debate, given the financial unsustainability of the current system, is over alternative proposals for reforming the system.

On one side of the debate are proposals to allow workers to privately invest some or all of their payroll taxes through individual accounts. These proposals may, or may not, include changes in the current system, such as reductions in government-provided benefits. Some may include using additional revenues, particularly general revenue, as a method of financing the transition. On the other side are proposals to prop up the current system by raising taxes, slashing benefits, or allowing the government to invest in private capital markets. These proposals contain significant costs and risks for both individuals and the American economy. And they offer none of the benefits of individual accounts.

Opponents' alternatives boil down to some very unpopular options—raising taxes, cutting benefits, or government investment in private financial assets.

The American people deserve a fair and honest debate about Social Security reform. They deserve to see the various proposals side by side so that they can compare the alternatives. Given the choice, we can be confident that Americans will choose to take control over their retirement funds through individual accounts.

Perhaps that's why opponents of privatization prefer not to talk about their alternatives.

Notes

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2. William Jefferson Clinton, Speech at the Great Social Security Debate, Albuquerque, N.M., July 27, 1998.

3. Henry Aaron, Testimony before the Senate Committee on Finance, 106th Cong., 1st sess., January 19, 1999.

4. Jim Kolbe and Charles Stenholm, Letter to House Speaker Dennis Hastert and Minority Leader Richard Gephardt, November 21, 2001.

5. President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans: Report of the President's Commission,* December 21, 2001, p. 151.

6. Robert Friedland and Laura Summer, "Demography Is Not Destiny," National Academy on an Aging Society," Washington, 2001, p. 61.

7. Joseph White, *False Alarm: Why the Greatest Threat to Social Security and Medicare Is the Campaign to "Save" Them* (Baltimore: Johns Hopkins University Press, 2001), pp. 12–13.

8. Kenneth Apfel, "Social Security Standoff," *Washington Post,* April 11, 2001.

9. Lisa Maatz, Testimony submitted to the President's Commission to Strengthen Social Security, August 2001.

10. Vincent R. Sombrotto, Testimony before the President's Commission to Strengthen Social Security, October 18, 2001.

11. Robert M. Ball (with Thomas N. Bethell), *Straight Talk about Social Security: An Analysis of the Issues in the Current Debate* (New York: Century Foundation Press, 1998).

12. Jeff Faux, Statement submitted to the White House Conference on Social Security, December 8, 1998.

13. Teresa Ghilarducci, Statement submitted to the White House Conference on Social Security, December 8, 1998.

14. Dean Baker and Mark Weisbrot, *Social Security: The Phony Crisis* (Chicago: University of Chicago Press, 1999), p. 117.

15. Robert Myers, Statement submitted to the White House Conference on Social Security, December 8, 1998.

16. Congressional Budget Office, "Aggregate Income Effects of Changes in Social Security Taxes," August 1982, p. 30.

17. Aldona Robbins and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Institute for Research on the Economics of Taxation, Washington, 1991, pp. 14–15.

18. Ralph Smith et al., *Social Security: A Primer* (Washington: Congressional Budget Office, 2001), pp. 76–79.

19. The lifetime net tax rate can be defined as the excess of the present value of lifetime Old Age and Survivors Insurance taxes over the present value of lifetime Social Security benefits. Jagadeesh Gokhale, "The Impact of Social Security Reform on Low-Income Workers," Cato Institute Social Security Paper no. 23, December 6, 2001, pp. 2–3.

20. National Committee to Preserve Social Security and Medicare, Statement to the President's Commission to Strengthen Social Security, September 6, 2001.

21. AFL-CIO, "Social Security: Options to Strengthen

Social Security for Working Families," www.aflcio.org/socialsecurity/strength/htm.

22. Hans Reimer, Testimony before the President's Commission to Strengthen Social Security, October 5, 2001.

23. Heidi Hartmann, Catherine Hill, and Lisa Witter, "Strengthening Social Security for Women," National Council of Women's Organizations, Task Force on Women and Social Security, July 1999, p. 11.

24. Maatz.

25. Baker and Weisbrot, p. 117.

26. Ball (with Bethell), pp. 10–11.

27. D. Mark Wilson, "Removing Social Security's Tax Cap on Wages Would Do More Harm Than Good," Heritage Foundation Center for Data Analysis Report no. 01-07, October 17, 2001, p. 5.

28. Ibid., p. 6.

29. Ibid., pp. 9–10.

30. Ibid., p. 3. Total repeal of the cap would do considerably more for trust fund solvency, but that would be the result of running fat surpluses today, which would be spent, then "redeeming" the bonds in the trust fund in the future. Unless today's surpluses were actually saved, a very problematic scenario, we would actually be worse off, because benefit obligations would rise.

31. In addition to the economic consequences of using general tax revenues to finance the current system, it is also worth noting that general revenue financing would represent a significant departure from Social Security's traditional structure as a payroll-tax-financed contributory social insurance program. That would transform Social Security into something much more closely resembling traditional welfare programs, something the designers sought to avoid.

32. See, for example, Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998), pp. 187–94.

33. As President Clinton's fiscal year 2000 budget explained: "[Trust fund] balances are available to finance future benefit payments . . . but only in a bookkeeping sense. . . . They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that . . . will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits." Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2000* (Washington: Government Printing Office, 2000), p. 337.

34. Robert Shapiro, "Nest Eggs, Over Easy," *Washington Monthly,* November 2001.

35. There is also the question of whether cutting taxes may do more to stimulate the economy than repaying debt. For example, $1 in tax cuts may save people and the economy more than just a dollar. In fact, because tax cuts reduce economic distortions (such as reducing savings and investment), a $1 tax cut saves the economy at least $1.25. Moreover, $1 in tax cuts doesn't actually cost the government $1 in lost revenue. Because taxpayers will save and invest more, work more, start more businesses, and evade taxes less, the government will lose only about 75 percent of the officially scored tax cut. So the $1.35 trillion tax cut will cost the government only about $1 trillion over 10 years. U.S. Congress, Joint Economic Committee, "Economic Benefits of Personal Income Tax Reductions," April 2001.

36. Roger Hickey, Testimony before the President's Commission to Strengthen Social Security, October 5, 2001.

37. U.S. Congress. A number of empirical studies have examined the responsiveness of taxable income to changes in marginal tax rates. In a 1987 paper, Lawrence Lindsey found an elasticity ranging from 1.05 to 2.75 with a midpoint estimate of 1.6 to 1.8. Lawrence Lindsey, "Individual Taxpayer Response to Tax Cuts, 1982–84, With Implications for the Revenue Maximizing Tax Rate," *Journal of Political Economy* 33 (1987). Other studies report similar levels of responsiveness. Martin Feldstein, "The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Act," *Journal of Political Economy* 103, no. 3 (1995); and Gerald Auten and Robert Carroll, "Taxpayer Behavior and the 1986 Tax Reform Act," U.S. Treasury, Office of Tax Analysis, July 1994. Recent studies suggest a somewhat lower, but still substantial, response. See, for example, Jonathan Gruber and Emmanuel Saez, "The Elasticity of Taxable Income: Evidence and Implications," National Bureau of Economic Research Working Paper no. 7512, January 2000; and Gerald Auten and Robert Carroll, "The Effect of Income Taxes on Household Income," *Review of Economics and Statistics* 81 (1999).

38. Amitai Etzioni, "Should We End Social Security? A Community Approach," Dow Jones News Service, September 1, 1998.

39. AFL-CIO.

40. Henry Aaron and Robert Reischauer, *Countdown to Reform: The Great Social Security Debate* (New York: Century Foundation, 2001), pp. 113–14.

41. Dean Baker, "False Poverty: The Nation Can Afford to Pay for Its Elderly," *Aging Today,* March–April 2000.

42. Baker and Weisbrot, p. 118.

43. Carrie Lips, "State and Local Government Retirement Programs: Lessons in Alternatives to Social Security," Cato Institute Social Security Paper no. 16, March 17, 1999.

44. National Committee to Preserve Social Security and Medicare.

45. Aaron and Reischauer, pp. 112–13.

46. Dean Baker, "Social Security Myth #2—There Won't Be Anything for Me," Center for Economic and Policy Research, February 20, 2001.

47. President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*.

48. Henry Aaron, Alicia Munnell, and Peter Orszag,

"Social Security Reform: The Questions Raised by the Plans Endorsed by President Bush's Social Security Commission," Washington, Century Foundation and Center on Budget and Policy Priorities, November 30, 2001.

49. Quoted in "Propping Up Social Security," *Business Week,* July 19, 1976.

50. Shapiro.

51. Apfel.

52. Robert Ball, Testimony before the House Ways and Means Committee, Subcommittee on Social Security, 105th Cong., 2d sess., June 3, 1998.

53. Alicia Munnell, Testimony before the House Ways and Means Committee, Subcommittee on Social Security, 105th Cong., 2d sess., June 3, 1998.

54. Current benefits are determined on the basis of wages during the highest-earning 35 years, with all years before the worker reaches age 65 indexed to reflect real wage growth and inflation. These earnings are then divided by 420 months to yield Average Indexed Monthly Earnings. Social Security benefits are then calculated by a progressive formula: 90 percent of the first $455 of the AIME, 32 percent of the next $2,286, and 15 percent of the remaining AIME. Obviously, including additional low-income years or years with zero earnings in the AIME calculation would lower that amount and therefore benefits.

55. Aaron and Reischauer, pp. 106–10.

56. Gary Burtless, Testimony before the Senate Budget Committee, 106th Cong., 1st sess., January 19, 1999.

57. Ghilarducci.

58. Aaron and Reischauer, p. 104.

59. Munnell.

60. Reimer.

61. Aaron, Testimony.

62. National Committee to Preserve Social Security and Medicare.

63. Maatz.

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65. James Packard Love, *Economically Targeted Investing: A Reference for Public Pension Funds* (Sacramento: Institute for Fiduciary Education, 1989).

66. Ibid.; and Carolyn Peterson, *State Employee Retirement Systems: A Decade of Change* (Washington: American Legislative Exchange Council, 1987).

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77. Ibid., pp. 4–5.

78. President's Commission to Strengthen Social Security, *Interim Report,* p. 25.

79. Hartmann, Hill, and Witter, pp. 6–11.

80. Ibid., Table 1, p. 11.

81. Aaron would partially offset the impact for low-income women by increasing survivors' benefits and establishing "earnings sharing" between spouses.

82. Gokhale, pp. 4–7.

83. For a discussion of these proposals, see Darcy Ann Olsen, "Social Security Reform Proposals: USAs, Clawbacks, and Other Add-Ons," Cato Institute Briefing Paper no. 47, June 11, 1999.

85. For evidence from participation in 401(k) programs, see William Bassett, Michael Flemming, and Anthony Rodriguez, "How Workers Use 401(k) Plans: The Participation, Contribution, and Withdrawal Decisions," *National Tax Journal* 11, no. 2 (June 1998).

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