

## **4. Social Security**

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

Social Security is not only the largest American government program, it is the largest government program in the world. Roughly 40 million Americans receive Social Security benefits, and every working American pays Social Security taxes. Indeed, nearly 80 percent of Americans pay more in Social Security taxes than they pay in federal income taxes.

Social Security has long been considered politically untouchable—the “third rail of American politics.” But now a new consensus has emerged. Given Social Security’s failing finances, declining rate of return, and other inequities, the American people recognize the need to dramatically restructure the nation’s troubled retirement program. Polls show strong public support for transforming Social Security from its current pay-as-you-go structure to a program based on savings and investment.

With the public supporting Social Security reform and large budget surpluses available to help finance the transition, the 107th Congress has a unique opportunity to remake Social Security and provide future generations with a sound and secure retirement.

### ***Why Privatize Social Security?***

There are five main reasons to privatize Social Security.

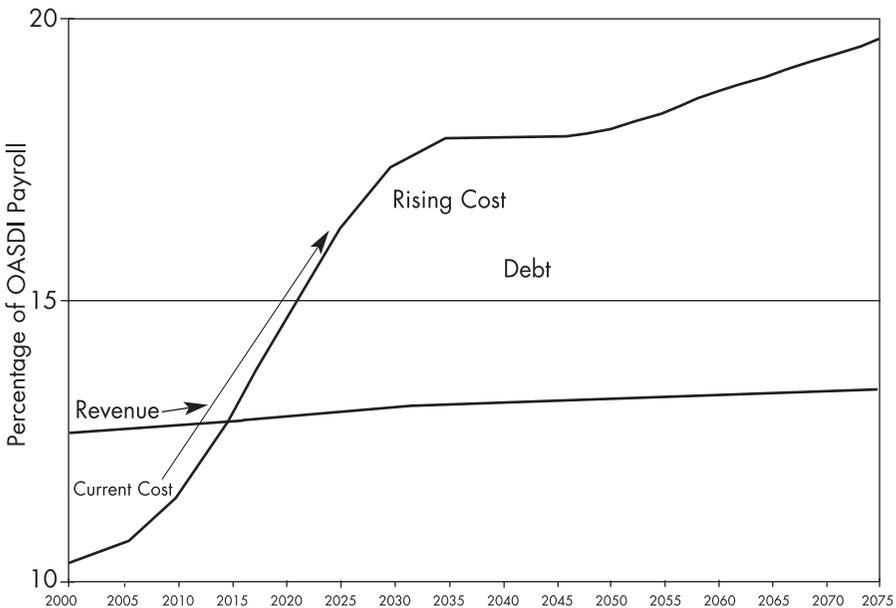
#### ***Keeping Social Security Solvent***

Social Security is going bankrupt. The federal government’s largest spending program, accounting for nearly 22 percent of all federal spending, faces irresistible demographic and fiscal pressures that threaten the future retirement security of today’s young workers. According to the 2000 report

of the Social Security system’s Board of Trustees, in 2015, just 15 years from now, the Social Security system will begin to run a deficit (Figure 4.1). That is, it will begin to spend more on benefits than it brings in through taxes. Anyone who has ever run a business—or balanced a checkbook—understands that when you are spending more than you are bringing in, something has to give: you need to start either earning more money or spending less to keep things balanced. For Social Security, that means either higher taxes or lower benefits.

In theory, Social Security is supposed to continue paying benefits after 2015 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide enough money to guarantee benefits until 2037, when it will be exhausted. But one of Washington’s dirty little secrets is that there really isn’t a trust fund. The government spent that money long ago to finance general government spending and hide the true size of the federal budget deficit. The trust fund now consists only of IOUs—promises that at some time in the future the government will replace that money, which can only be done by collecting more taxes or issuing even more debt.

**Figure 4.1**  
**Social Security Revenue vs. Cost of Benefits**



Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2037. At that point, Social Security will have to rely solely on revenue from the payroll tax. But that revenue will not be sufficient to pay all promised benefits.

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

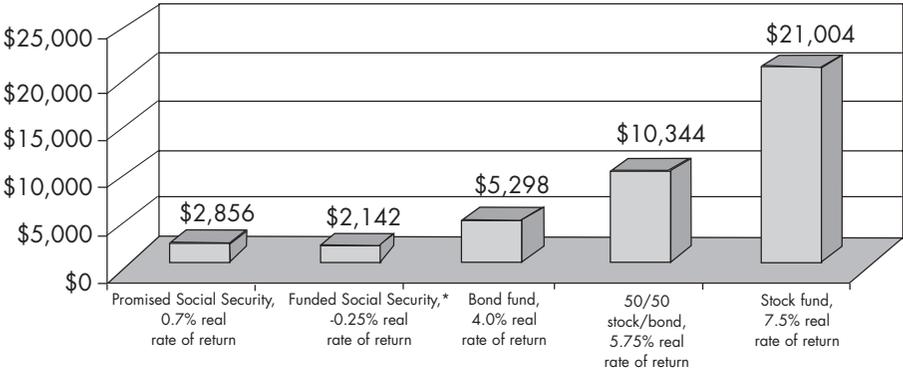
### *A Better Deal for Young Workers*

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

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

This is a measure of what Social Security is costing average families today—\$1 million over their lifetimes, or about three times the benefits of Social Security. Moreover, this financial crisis exists today, not some time in the future. Every year that workers are forced to participate only in Social Security, without the freedom to choose private alternatives, they

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



SOURCE: Cato Institute’s calculator at [www.socialsecurity.org](http://www.socialsecurity.org).

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

are irreversibly suffering a bigger and bigger portion of this lifetime loss. Roughly, the average two-earner couple is losing \$25,000 each year they are forced to go without a private option.

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

*Savings and Economic Growth*

Social Security operates on a pay-as-you-go basis; almost all of the funds coming in are immediately paid out to current beneficiaries. This system displaces private fully funded alternatives under which the funds coming in would be saved and invested for the future benefits of today’s workers. The result is a large net loss of national savings, which reduces capital investment, wages, national income, and economic growth. More-

over, by increasing the cost of hiring workers, the payroll tax substantially reduces wages, employment, and economic growth as well.

Shifting to a private system, with hundreds of billions of dollars invested in individual retirement accounts each year, would likely produce a large net increase in national savings, depending on how the government financed the transition. This would increase national investment, productivity, wages, jobs, and economic growth. Replacing the payroll tax with private retirement contributions would also improve economic growth, because the required contributions would be lower and those contributions would be seen as part of a worker's direct compensation, stimulating more employment and output.

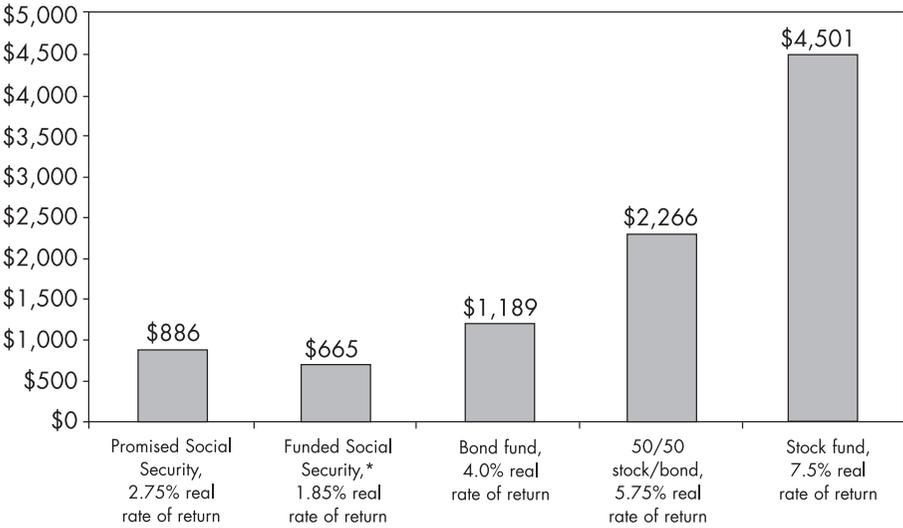
Harvard economist Martin Feldstein estimates that privatization of Social Security would produce \$10 trillion to \$20 trillion in present value net benefits to America. That is essentially his estimate of the present value of the improved economic performance that would result from the reform. Most of that net benefit would probably come in the form of the higher returns and benefits earned for retirees through the private investment accounts. But some would also come in the form of higher wages and employment for working people.

### *Helping the Poor*

Low-income workers would be among the biggest winners under a private system. As shown in Figure 4.3, a private, invested system would pay low-income workers at least two to three times the benefits promised by Social Security. And that does not take into account the fact that blacks and other minorities, and the poor in general, have below-average life expectancies. As a result, they tend to live fewer years in retirement and collect less in Social Security benefits than do whites. In a private, invested system, by contrast, they would each retain control over the funds paid in and could pay themselves higher benefits over their fewer retirement years, or leave more to their children or other heirs.

The higher returns and benefits of a private, invested system would be most important to low-income families, as they most need the extra funds. The funds saved in the individual retirement accounts, which could be left to the children of the poor, would also greatly help families break out of the cycle of poverty. Similarly, the improved economic growth, higher wages, and increased jobs that would result from privatization would be most important to the poor. Moreover, without reform, low-income workers will be hurt the most by the higher taxes or reduced benefits that will be

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



SOURCE: Cato Institute’s calculator at [www.socialsecurity.org](http://www.socialsecurity.org).

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

necessary if we continue on our current course. Averting a financial crisis and its inevitable results would consequently be most important to low-income workers.

In addition, with average- and low-wage workers accumulating huge sums in their own investment accounts, the distribution of wealth throughout society would become far broader than it is today. That would occur, not through the redistribution of existing wealth, but through the creation of new wealth, far more equally held. Because privatizing Social Security would turn every worker into a stockowner, the old, senseless division between labor and capital would be eroded. Every laborer would become a capitalist. The socialist dream of the nation’s workers owning its businesses and industries would be effectively achieved. At the same time, as the nation’s workers became capitalists, support for free-market, pro-growth economic policies would increase in all sectors of society. That social effect is one of the least cited but most important reasons for privatizing Social Security.

## *Ownership and Control*

After all the economic analysis, however, perhaps the single most important reason for privatizing Social Security is that it would give American workers true ownership of and control over their retirement benefits.

Many Americans believe that Social Security is an “earned right.” That is, because they have paid Social Security taxes they are entitled to receive Social Security benefits. The government encourages this belief by referring to Social Security taxes as “contributions,” as in the Federal Insurance Contributions Act (FICA). However, the U.S. Supreme Court has ruled, in the case of *Flemming v. Nestor*, that workers have no legally binding contractual or property right to their Social Security benefits, and those benefits can be changed, cut, or even taken away at any time.

As the Court stated, “To engraft upon Social Security a concept of ‘accrued property rights’ would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands.” That decision built on a previous case, *Helvering v. Davis*, in which the Court had ruled that Social Security is not a contributory insurance program, stating that “the proceeds of both the employer and employee taxes are to be paid into the Treasury like any other internal revenue generally, and are not earmarked in any way.”

In effect, Social Security turns older Americans into supplicants, dependent on the political process for their retirement benefits. If they work hard, play by the rules, and pay Social Security taxes their entire lives, they earn the privilege of going hat in hand to the government and hoping that politicians decide to give them some money for retirement.

In contrast, under a privatized Social Security system, workers would have full property rights in their private accounts. They would own their accounts and the money in them the same way they own their individual retirement accounts (IRAs) or 401(k) plans. Their retirement benefits would not depend on the whims of politicians.

## **A Private System**

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

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

PRAs would be managed by the private investment industry, and workers would be free to choose the fund manager that best met their individual needs and could change managers whenever they wished. The government would establish regulations on portfolio risk to prevent speculation and protect consumers. Reinsurance mechanisms would be required to guarantee fund solvency.

The government would continue to provide a safety net in the form of a guaranteed minimum pension benefit. If upon retirement the balance in an individual's PRA was insufficient to provide an actuarially determined retirement annuity equal to the minimum wage, the government would provide a supplement sufficient to bring the individual's monthly income up to that level.

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

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

By comparison, relying on the current Social Security system is extremely risky. With Social Security's unfunded liabilities exceeding \$21 trillion and workers having no legal right to their benefits, a young worker entering the Social Security system is gambling on what benefits a president and Congress *45 years from now* will decide to bestow. Given Social Security's already low rate of return to young workers, the political risk of staying in Social Security far exceeds the market risk of private investment.

### ***Principles for Reform***

As it approaches the historic debate over Social Security reform, Congress should keep in mind five basic principles.

### *Solvency Is Not Enough*

Workers deserve the best possible deal for their dollar. With Social Security facing a financial crisis—it will begin running a deficit in just 15 years—much attention has been focused on ways to keep the program solvent. Theoretically, that could be accomplished by raising taxes or cutting benefits. But Social Security faces a second crisis as well: Young workers will receive a negative rate of return from the program. They will get less back in benefits than they pay in taxes. That low return, and other inequities, particularly disadvantages women, the poor, and minorities. Any Social Security reform must reverse this trend, raising the rate of return and providing higher retirement benefits.

### *Individuals, Not Government, Should Invest*

The only way to increase Social Security's rate of return is to invest Social Security taxes in real capital assets. This should be done through the creation of individually owned accounts, not by allowing the government to directly invest payroll taxes. Individual accounts would give workers ownership of and control over their retirement funds, allowing them to accumulate wealth and pass that wealth on to their heirs; it would also give them a greater stake in the American economic system. Government investment would allow the federal government to become the largest shareholder in every American company, posing the potential threat to corporate governance and the specter of social investing.

### *Maximize Consumer Choice*

Workers should be given as wide a range of investment opportunities as possible, consistent with regulatory safeguards against fraud or speculation. While investing in “Singapore derivatives” is clearly not envisioned, there is no reason to limit workers to only two or three index funds. As much as possible, the existing retirement savings infrastructure should be used, meaning workers would have a large number of safe and secure options. Moreover, a safety net would guarantee that no senior would end up in poverty as a result of bad investments.

### *Don't Touch Grandma's Check*

Benefits to the currently retired and nearly retired should not be reduced. Indeed, by explicitly recognizing benefits owed to current retirees, privatization would guarantee those benefits in a way that the current political system does not. Making the transition to a new system while guaranteeing

current benefits means that the government will have to issue debt, cut current spending, or sell assets, but those “transition costs” will be substantially less than the costs of maintaining the current system.

### *More Privatization Is Better Than Less*

You don’t cut out half a cancer. Given the advantages of a privatized Social Security system, there is no excuse for stopping at the privatization of only 2–3 percent of payroll taxes. Once Congress has conceded that private capital investment can provide better and more secure retirement benefits, it should press on and allow workers to control the maximum feasible amount of their retirement income.

### ***The Transition***

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

Although that sounds like an intimidating figure, it should be understood that this is not a new cost. It is really just making explicit an already existing unfunded obligation. The federal government already cannot fund as much as \$21 trillion of Social Security’s promised benefits. Privatizing Social Security, therefore, will actually reduce the amount of debt we owe.

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

Of course there will be a temporary cash flow problem while we make the transition. We will have to find the revenues to pay benefits to current retirees. While any financing mechanism will be political, involving some

combination of debt, transfers from general revenues, asset sales, and the like, the expected budget surplus offers a good place to start. If both parties are willing to forgo new spending programs and junk tax cuts, we can begin the transition to a new, improved Social Security system.

In addition to using the budget surplus, there are several methods of financing the transition. For example, a small portion of the payroll tax could be continued temporarily. Workers could be allowed to invest 8 or 10 percentage points (out of 12.4 percent) with the remainder temporarily being used to fund a portion of continued benefits. Congress could also identify additional spending cuts and use the funds saved to finance the transition. Because much federal government spending is wasteful or counterproductive, such cuts would not be any sacrifice for society—indeed, the cuts themselves might provide many benefits. A list of potential cuts can be found in Chapter 27. The government could also sell many assets that it currently owns. Finally, the government could issue bonds to spread the cost of transition over several generations. It is important to understand that this is not new debt; it is simply the explicit recognition of an existing implicit debt under the current system.

## **Conclusion**

The American people have shown themselves ready for fundamental Social Security reform. Now is the time for Congress to act. There is little that the 107th Congress could do that would have a more profound impact on the lives of the American people.

## **Suggested Readings**

- Beard, Sam. *Restoring Hope in America: The Social Security Solution*. San Francisco: Institute for Contemporary Studies, 1996.
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- Rounds, Charles. "Property Rights: The Hidden Issue of Social Security Reform." Cato Institute Social Security Paper no. 19, April 19, 2000.

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