Cato Institute Social Security Choice Paper No. 7: Privatizing Social Security: The $10 Trillion Opportunity

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Executive Summary

As America moves into the 21st century, two public policy issues are becoming increasingly important: the need to reform Social Security and the need to spur economic growth and raise real wages. Recent evidence suggests that it may be possible to solve both problems simultaneously.

Our current Social Security system is acting as a drag on economic growth in two important ways. First, the payroll tax distorts the supply of labor and the type of compensation sought by workers. These losses are inevitable because of the low return implied by the pay-as-you-go character of the unfunded Social Security system. Second, the system reduces national savings and investment.

Privatizing Social Security, transforming it from an unfunded pay-as-you-go system to a system of mandatory private savings accounts, would solve both of those problems and increase economic growth.

Under the current Social Security system, each generation now and in the future loses the difference between the return to real capital that would be obtained in a funded system and the much lower return in the existing unfunded program. Shifting to a privatized system of individual mandatory accounts that can be invested in a mix of stocks and bonds would permit individuals to obtain the full real pretax rate of return on capital. This would mean a larger capital stock and a higher national income.

Conservative assumptions imply that Social Security privatization would raise the well-being of future generations by an amount equal to 5 percent of gross domestic product (GDP) each year as long as the system lasts. Although the transition to a funded system would involve economic as well as political costs, the net present value of the gain would be enormousÃ³as much as $10-20 trillion.

Such a private savings program would solve Social Security's long-run financial problems without the necessity for either huge tax increases or draconian benefit cuts. At the same time, it would yield enormous benefits to the economy. In short, privatizing Social Security can increase real incomes for everyone while ensuring a dignified retirement for future retirees.

Introduction

Although reforming the Social Security retirement program is an issue of enormous importance, elected officials are

still unwilling to confront this serious but politically dangerous problem. Eventually, however, the system's deteriorating financial condition will force major reforms.[1] Whether those reforms are good or bad, whether they deal with the basic economic problems of the system or merely protect the solvency of existing institutional arrangements, is the crucial policy issue. Simply protecting the solvency of the unfunded system by tampering with taxes and benefits will perpetuate existing adverse effects on labor markets and national saving. Shifting to a system of funded individual accounts can produce a major increase in national income and in the well-being of the population.

Central to the analysis of Social Security's impact on the economy is the concept of "Social Security wealth," defined as the present actuarial value of the Social Security benefits to which the current adult population will be entitled at age 65 (or are already entitled to if they are older than 65) minus the present actuarial value of the Social Security taxes that they will pay before reaching that age. Social Security wealth has now grown to about $9 trillion or more than the total value of GDP, which is equivalent to more than $40,000 for every adult in the country.[2] Its value substantially exceeds that of all other assets for the vast majority of American households. In the aggregate, Social Security wealth is equal to about half of all private financial wealth.

Social Security wealth is of course not real wealth but only a claim on current and future taxpayers. Instead of labeling this key magnitude Social Security wealth, it could more accurately be called the nation's Social Security liability. Like ordinary government debt, Social Security wealth has the power to crowd out private capital accumulation. And it will continue to grow as long as our current system remains unchanged, displacing an ever larger stock of capital.

The $9 trillion Social Security liability is more than twice the official national debt. Even if the traditional deficit is eliminated in the year 2002, so that the traditional national debt is no longer increasing, the national debt in the form of the Social Security liability is likely to increase that year under current law by about $500 billion.

Looking further into the future, the aggregate Social Security liability will grow as the population expands, as it becomes relatively older, and as incomes rise. Government actuaries predict that, under existing law, the tax rate required to pay each year's Social Security benefit will rise over the next 50 years from the present level of slightly less than 12 percent to more than 18 percent and perhaps to as much as 23 percent.[3]

The financial problems of the system are therefore serious indeed. This essay, however, will not discuss the financial insolvency of Social Security but will focus instead on the more fundamental economic effects of continuing with an unfunded system. Dealing appropriately with these economic effects will also solve the financial problems.

Labor Market Distortions

The Social Security payroll tax distorts the supply of labor and the form of compensation. These losses are inevitable because of the low return implied by the pay-as-you-go character of the unfunded Social Security system.

Unlike private pensions and individual retirement accounts, the Social Security system does not invest the money that it collects in stocks and bonds but pays those funds out as benefits in the same year that they are collected. (Although the system has been accumulating a fund since 1983 to smooth the path of tax rates, more than 90 percent of payroll tax receipts are still paid out immediately as benefits, and the assets in the Social Security trust fund are only about 5 percent of the Social Security liabilities.)

The rate of return that individuals earn on their mandatory Social Security contributions is therefore far less than they could earn in a private pension or in a funded Social Security system. An unfunded program with a constant tax rate provides a positive rate of return that is roughly equal to the rate of growth of the payroll tax base.

The average growth of real wages since 1960Ã³2.6 percentÃ³can serve as a reasonable estimate of what an unfunded Social Security program can yield over the long-term future. In contrast, the real pretax return on nonfinancial corporate capital (i.e., profits before all taxes plus the net interest paid) averaged 9.3 percent over the same period.[4] Although individuals do not earn the full 9.3 percent pretax return even in Individual Retirement Accounts (IRAs) and 401(k) accounts because of federal and state corporate taxes, a funded retirement system could deliver the full 9.3 percent pretax return to each individual saver if the government credited back the corporate tax collections.[5]

A simplified example will indicate the magnitude of the tax wedge implied by the Social Security program. Consider an employee who contributes $1,000 to Social Security at age 50 to buy benefits to be paid at age 75. With a 2.6 percent yield, the $1,000 grows to $1,900 after the 25 years. In contrast, a yield of 9.3 percent would allow the individual to buy the same $1,900 retirement income for only $206. Thus, forcing individuals to use the unfunded system dramatically increases their cost of buying retirement income. In the example, a funded plan would permit the individual to buy the same retirement income with a 2.5 percent contribution instead of the 12 percent payroll tax. The 9.5 percent difference is a pure real tax for which the individual gets nothing in return.

The distorting effect of this tax is much larger than one might at first think. The net Social Security tax rate is imposed on top of federal and state income taxes. The federal marginal tax rate is 28 percent (for single individuals with taxable incomes over $23,000 and married couples with combined incomes over $38,000), and the typical state income tax rate is 5 percent. The Social Security tax therefore raises the total marginal tax rate to more than 40 percent and substantially exacerbates the distortions and waste caused by the income tax.[6]

The combination of the income tax and the payroll tax distorts not only the number of hours that individuals work but also other dimensions of labor supply like occupational choice, location, and effort. It also distorts the form in which compensation is taken, shifting taxable cash into untaxed fringe benefits, nicer working conditions, etc. These distortions in the form of compensation are in effect distortions in the individual's pattern of consumption. They cause individuals to spend their potential income on things that they value less than those things that they could buy for cash. These distortions are dollar for dollar as important as the distortion in labor supply.[7]

In practice, these distortions are exacerbated by the haphazard relations between benefits and taxes that result from existing Social Security rules. For example, because benefits are based on the 35 years of highest earnings, most employees under age 25 receive no additional benefit for their payroll taxes. Because many married women and widows claim benefits based on their husbands' earnings, they also often receive no benefit in return for their payroll taxes. Because there is no extra reward for taxes paid at an early date, the effective tax rate for younger taxpayers can be a substantial multiple of the tax rate for older employees. The Social Security rules are so complex and so opaque that many individuals may simply disregard the benefits that they earn from additional work and act as if the entire payroll tax is a net tax no different in kind from the personal income tax.

The extra distortion that results from these very unequal links between incremental taxes and incremental benefits would automatically be eliminated in a privatized funded system with individual retirement accounts. Although it could also be eliminated within the existing unfunded system by creating individual Social Security accounts for each taxpayer, the larger labor market distortions that result from the low rate of return in an unfunded system cannot be eliminated without shifting to either a funded public system or a privatized system of individual retirement accounts.

Reduced National Saving

The loss that results from labor market distortions is not the only adverse effect of an unfunded Social Security system or even the largest one. Current and future generations lose by being forced to participate in a low-yielding, unfunded programÃ³i.e., by being forced to accept a pay-as-you-go implicit return of 2.6 percent when the real marginal product of capital is 9.3 percent. Even though capital income taxes now prevent individuals from receiving that 9.3 percent on their personal savings, the public as a whole does receive that full return; what individuals do not receive directly, they receive in the form of reductions in other taxes or increases in government services.

The extent to which an unfunded Social Security system causes a decline in national capital income and economic welfare depends on how individual saving responds to Social Security taxes and benefits and on how the government acts to offset the reductions in private saving. Let's look at some facts.

An individual who has average earnings during his entire working life and who retires at age 65 with a "dependent spouse" now receives benefits equal to 63 percent of his earnings during the full year before retirement. Because the Social Security benefits of such an individual are not taxed, those benefits replace more than 80 percent of peak preretirement after-tax income. Common sense and casual observation suggest that individuals who can expect such a

high replacement rate will do little saving for their retirement. Such saving as they do during their preretirement years is more likely to be done as a precautionary balance to deal with unexpected changes in income or consumption. Not surprisingly, the median financial assets of households with a head of household aged 55 to 64 were only $8,300 in 1991, substantially less than six months' income. Even if we look beyond financial wealth, the median net worth (including the value of the home) among all households with a head of household under 65 years of age was only $28,000.

To get a sense of the order of magnitude of the annual loss, it is helpful to begin with the simplest case in which each dollar of Social Security wealth reduces real private wealth by a dollar. The forgone private wealth would have earned about 9.3 percent, whereas the unfunded Social Security system provides a return equal to about 2.6 percent. The population incurs a loss equal to the difference between those two returns. The annual loss of real income would be 6.7 percent of the $9 trillion of Social Security wealthÃ³an amount equal to $600 billion or 8 percent of total GDP.

Of course, each dollar of Social Security wealth does not necessarily replace exactly a dollar of real wealth. To the extent that Social Security induces earlier retirement, individuals will save more than they otherwise would. Social Security also affects private saving by providing a real annuity. And there are some individuals who, because they are irrational or myopic, do not respond at all to the provision of Social Security benefits. A number of research studies have been done on the extent to which Social Security wealth depresses saving and replaces real wealth.[8] Although none of these is a definitive study that establishes a precise measure of the substitution of Social Security wealth for other household wealth, taken together these studies do imply that the Social Security program causes each generation to reduce its savings substantially and thereby to incur a substantial loss of real investment income. Even a conservative estimate that each dollar of Social Security wealth displaces only 50 cents of private wealth accumulation implies that the annual loss of national income would exceed 4 percent of GDP.

The Gain from Privatization

Under the current Social Security system, each generation now and in the future loses the difference between the return to real capital that would be obtained in a funded system and the much lower return in the existing unfunded program. Shifting to a privatized system of individual mandatory accounts that can be invested in a mix of stocks and bonds would permit individuals to obtain the full real pretax rate of return on capital. This would mean a larger capital stock and a higher national income.

In addition, eliminating the payroll tax would reduce the distortions in work effort and form of compensation that currently depress the productivity of the economy and the real standard of living. When the system of funded individual accounts is fully implemented, the mandatory contributions required to fund the current and projected levels of benefits would be only about 3 percent of payroll, far lower than the payroll tax, which is expected to rise from 12.4 percent now to at least 20 percent over the next 35 years.

Conservative assumptions imply that Social Security privatization would increase the economic well-being of future generations by an amount equal to 5 percent of GDP each year as long as the system lasts. Although the transition to a funded system would involve economic as well as political costs, the net present value of the gain would be enormousÃ³as much as $10-20 trillion.[9]

Conclusion

The rapidly deteriorating financial position of Social Security will eventually force politicians to deal with the problem of reform. The adverse impact of the current system on a wide variety of groupsÃ³including two-earner couples, the young, and the poorÃ³may embolden some politicians to go beyond patching up the current system to proposing more fundamental reforms than have been considered in the past. Instead of the usual mix of tax increases and benefit cuts, we can move to a system based on mandatory, individually owned private savings accounts.

Such a private savings program would solve Social Security's long-run financial problems without the necessity for either huge tax increases or draconian benefit cuts. At the same time, it would yield enormous benefits to the economy. In short, privatizing Social Security can increase real incomes for everyone while ensuring a dignified retirement for

future retirees.

Notes

A longer and more technical version of this lecture appears in the Papers and Proceedings of the American Economics Association *(American Economic Review,* Volume 86, no. 2, May 1996).

1. According to the most recent report of the Social Security system's Board of Trustees, Social Security will be insolvent by the year 2029, down from 2030 in last year's report. This represents the eighth time in the last 10 years that the insolvency date has been brought forward. But Social Security's problems actually begin not in 2029 but as early as 2012, the year in which the system begins to run a deficit. 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington: Government Printing Office), p.4.

2. This is a new estimate of Social Security wealth based on the detailed Social Security simulation model presented in Martin Feldstein and Andrew Samwick, "The Transition Path to Privatizing Social Security," National Bureau of Economic Research Working Paper no. 5761 (September 1996), forthcoming in *Privatizing Social Security,* to be published by the National Bureau of Economics Research.

3. Derived from 1996 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds

4. Martin Feldstein, Louis Dicks-Mireaux, and James Porterba, "The Effective Tax Rate and Pretax Rate of Return," *Journal of Public Economics* 21 (July 1993): 129-58, and Richard Rippe, "Further Gains in Corporate Profitability," *Economic Outlook Monthly,* August 1995.

5. Those taxes average 42 percent of pretax return. Ibid.

6. Economists measure this waste by the "deadweight loss" of the tax, i.e., the loss to the individual in excess of the revenue raised by the government. Economists can calculate that the incremental deadweight loss that results from the additional 9.5 percent net Social Security tax is equal to 4.7 percent of the product of the payroll tax base and the compensated elasticity of that tax base with respect to the net of tax share. That is about 10 times as large as the deadweight loss that would result if the Social Security tax were the only tax. For details of this calculation, see page 4 of the Ely lecture as published in the *American Economic Review.*

7. The deadweight loss due to the net Social Security tax is about 2.35 percent of the Social Security payroll tax base, a deadweight loss in 1995 of about $68 billion. This deadweight loss is about 1 percent of GDP and nearly one-fifth of total Social Security payroll tax revenue. It increases the deadweight loss of the personal income tax by 50 percent. Details of this calculation are presented on pages 4 and 5 of the Ely Lecture.

8. See, for example, Martin Feldstein and Anthony Pellechio, "Social Security and Household Wealth Accumulation: New Microeconometric Evidence," *Review of Economics and Statistics* 61 (August 1979): 361-68; Peter Diamond and J. A. Hausman, "Individual Retirement and Savings Behavior," *Journal of Public Economics* 23 (Feb.-Mar. 1984): 81-114; Alan Blinder, R. Gordon, and David Wise, "Social Security, Bequests, and Life Cycle Theory of Savings: Cross-Sectional Tests," in Alan Blinder, ea., *Inventory Theory and Consumer Behavior* (Ann Arbor, MI: University of Michigan Press, 1990), pp. 229-56; and Robert Barro, "The Impact of Social Security on National Savings," Washington, D.C., American Enterprise Institute, 1978.

9. The present value gain is the present value of annual gains of 5 percent of GDR Since the current level of GDP is now $7.5 trillion, a gain of 5 percent of that would be $375 billion. The annual gain would increase in proportion to the GDP and would therefore grow at about 3 percent per year in real terms. Discounting this at a real rate of 5 percent (approximately the rate of return net of tax that an individual investor received on the Standard and Poors portfolio over the period since 1970) implies a present value of $18.75 trillion.