ENTITLEMENT REFORM

4. Social Security

Congress should allow workers to privately invest at least half of their Social Security payroll taxes through individual accounts.

Social Security is not only the largest U.S. government program, accounting for roughly 23 percent of the federal budget; it is also the largest government program in the world. Few countries have budgets as large as the U.S. Social Security system. It is a program that touches almost every American. The Social Security payroll tax is the biggest tax paid by the average American family. In fact, nearly 80 percent of American workers pay more in Social Security payroll taxes than they do in federal income taxes. At the same time, millions of seniors rely on Social Security for their retirement income. More than half of seniors receive the majority of their retirement income through the program.

Yet Social Security is deeply flawed and facing a growing crisis. In less than 15 years, the national retirement program will begin to run a deficit, spending more on benefits than it takes in through taxes. The IOUs in the Social Security Trust Fund are merely a claim against future taxes, not real assets that can be used to pay benefits. Overall, the system is more than $26 trillion in debt.

Former president Bill Clinton laid out the very limited options for fixing the problem: raise taxes, cut benefits, or invest privately. Certainly it is possible to raise taxes or cut benefits enough to prop up the existing system for a little while longer. But the Social Security payroll tax is already the biggest tax that the average American family pays. Do we really want our legacy to our children and grandchildren to be the largest tax increase in American history? Cutting benefits is no better option. Already younger workers can expect a low, below-market return on their taxes. Benefit cuts would only make a bad deal worse.

82978$$CH4 12-08-04 07:30:47

That leaves private investment as the only viable option. By allowing younger workers to privately invest their Social Security taxes through individual accounts, we can

- help restore Social Security to long-term solvency, without massive tax increases;
- provide workers with higher benefits than Social Security would otherwise be able to pay;
- create a system that treats women, minorities, and young people more fairly;
- allow low-income workers to accumulate real, inheritable wealth for the first time in their lives; and
- give workers ownership of and control over their retirement funds.

Some people say that current budget deficits make Social Security reform, particularly individual accounts, impossible. They point to the ''transition cost'' of moving to individual accounts. Since current taxes are used to pay current beneficiaries, allowing younger workers to invest their taxes will require a replacement for current revenue to protect current retirees. But given Social Security's unfunded liabilities, the transition does not really represent a new cost. It is just making explicit an already implicit debt.

Of course, shifting to private investment would mean paying that debt now rather than later, so reforming Social Security will increase short-term budget deficits. But it will save trillions of dollars in the long term. In many ways, it is like refinancing your mortgage: you have to pay the points up front, but you save money in the long run.

Budget deficits are not a good thing. But to let current deficits stand in the way of Social Security reform is to saddle our children and grandchildren with a much bigger bill.

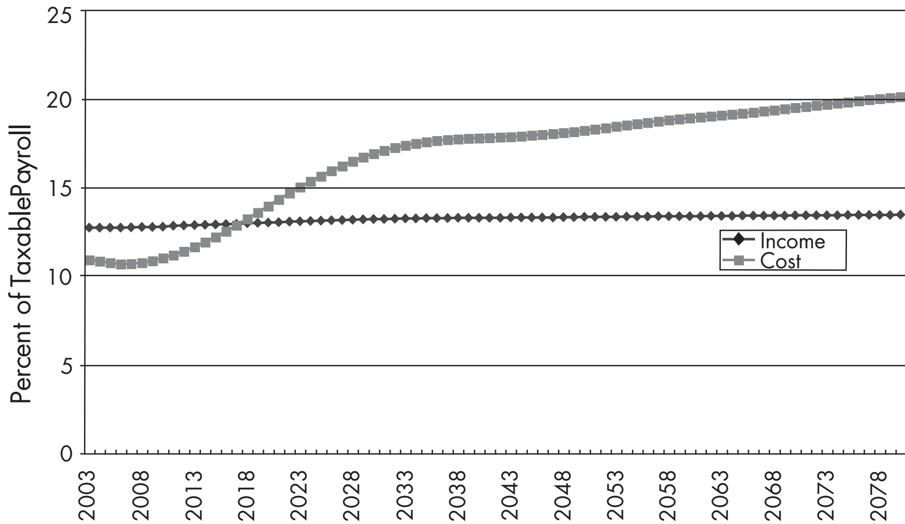
Quite simply, Social Security reform cannot be put off.

The Financial Crisis

Social Security as we know it is facing irresistible demographic and fiscal pressures that threaten the future retirement benefits of today's young workers. Although Social Security is currently running a surplus, according to the system's own trustees, that surplus will turn into a deficit within the next 15 years. That is, by 2018, Social Security will be paying out more in benefits than it takes in through taxes (Figure 4.1).

82978$$CH4 12-08-04 07:30:47

Figure 4.1
Current Social Security System



SOURCE: 2003 Trustees Report, Table IV.B1.

In theory, Social Security is supposed to continue paying benefits after 2018 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide sufficient funds to continue paying full benefits until 2042, after which it will be exhausted. At that point, *by law,* Social Security benefits will have to be cut by approximately 27 percent.

However, in reality, the Social Security Trust Fund is not an asset that can be used to pay benefits. Any Social Security surpluses accumulated to date have been spent, leaving a trust fund that consists only of government bonds (IOUs) that will eventually have to be repaid by taxpayers. As the Clinton administration's fiscal year 2000 budget explained it:

> These [Trust Fund] balances are available to finance future benefit payments and other Trust Fund expenditures—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, when redeemed, 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.

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2042. At that point, Social Security

82978$$CH4 12-08-04 15:10:41

will have to rely solely on revenue from the payroll tax—but that revenue will not be sufficient to pay all promised benefits. Overall, Social Security faces unfunded liabilities of nearly $26 trillion. Clearly, Social Security is not sustainable in its current form.

There are really few options for dealing with the problem. This opinion is not held just by supporters of individual accounts. As Clinton pointed out, the only ways to keep Social Security solvent are to (a) raise taxes, (b) cut benefits, or (c) get a higher rate of return through private capital investment. Henry Aaron of the Brookings Institution, a leading opponent of individual accounts, 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 yield assets,'' he told Congress in 1999.

The tax increases or benefit cuts would have to be quite large. To maintain benefits in the first year after Social Security starts running a deficit, the government must acquire revenues equivalent to $197 per worker. By 2042 the additional tax burden increases to $1,976 per worker, and by 2078 it reaches an astounding $4,193 per worker (in constant 2003 dollars). And it continues to rise thereafter. Functionally, that would translate into either a huge increase in the payroll tax, from the current 12.4 percent to as much as 18.9 percent by 2077, or an equivalent increase in income or other taxes.

A Declining Rate of Return

Social Security taxes are already so high, relative to benefits, that Social Security has clearly become a bad deal for younger workers, providing a low, below-market rate of return. As Figure 4.2 shows, that return has been steadily declining and is expected to be less than 2 percent for most of today's workers.

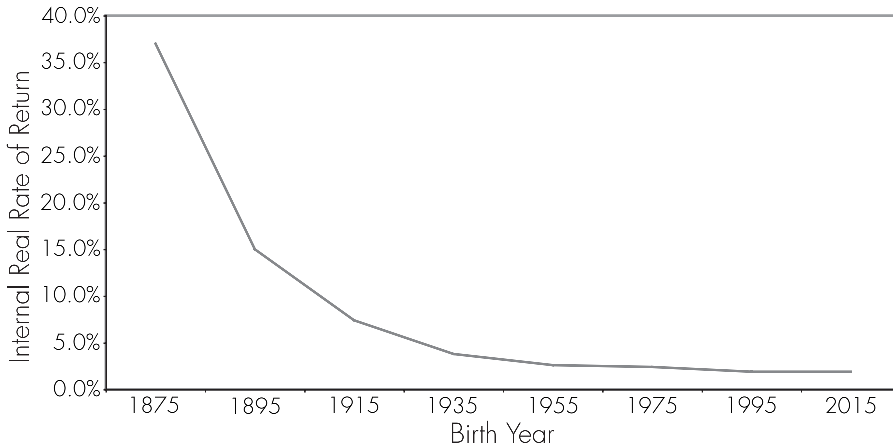
That poor rate of return means that many young workers' retirement benefits will be far lower than if they had been able to invest those funds privately. A system of individual accounts, based on private capital investment, would provide most workers with significantly higher returns. Those higher returns would translate into higher retirement benefits, leading to a more secure retirement for millions of seniors.

Savings and Economic Growth

Social Security operates on a pay-as-you-go (PAYGO) basis, with almost all of the funds coming in being immediately paid out to current

82978$$CH4 12-08-04 07:30:47

Figure 4.2
Inflation-Adjusted Internal Real Rate of Return from OASI



SOURCE: Dean R. Leimer, "Cohort-Specific Measures of Lifetime Net Social Security Transfers," Social Security Administration, Office of Research and Statistics, Working Paper no. 59, February 1994.

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. Moreover, 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 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 would be seen as part of a worker's direct compensation, stimulating more employment and output.

In 1997 Harvard economist Martin Feldstein estimated that if all Social Security payroll taxes were privately invested, it would produce $10 trillion to $20 trillion in present value net benefits to America. Most of that net benefit would probably come in the form of the higher returns and benefits

82978$$CH4 12-08-04 07:30:47

earned for retirees through the private investment accounts. But some would also come in the form of higher wages and greater employment.

Helping the Poor and Minorities

Low-income workers would be among the biggest winners under a system of privately invested individual accounts. Private investment would pay low-income workers significantly higher benefits than can be paid by Social Security. And that does not take into account the fact that blacks, Hispanics, and the poor 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 system of individual accounts, by contrast, they would 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 privately 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 children, 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 an investment-based Social Security system 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 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 a system of individual accounts would turn every worker into a stockowner, the old division between labor and capital would be eroded. Every laborer would become a capitalist.

Ownership and Control

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

82978$$CH4 12-08-04 07:30:47

Many Americans believe that Social Security is an ''earned right.'' That is, they think that, because they have paid Social Security taxes, they are entitled to receive Social Security benefits. The government encourages that 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 system of individual accounts, 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 future political choices.

Simple Rules for Reform

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

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

In developing a plan to reform Social Security, Congress should bear in mind these simple rules:

82978$$CH4 12-08-04 07:30:47

Solvency Is Not Enough

The goal of Social Security reform should be to provide workers with the best possible retirement option, not simply to find ways to preserve the current Social Security system. After all, if solvency were the only goal, that could be accomplished with tax increases or benefit cuts, no matter how bad a deal that provided younger workers. Successful Social Security reform will result in a solvent system, not just in the short run, but sustainable over time as well. It will also improve Social Security's rate of return; provide better retirement benefits; treat women, minorities, and low-income workers more fairly; and give workers real ownership and control of their retirement funds.

Half Measures Avail Us Naught

You don't cut out half a cancer. Many proposals for Social Security reform would allow workers to privately invest only a small portion of their payroll taxes and continue to rely on the existing PAYGO Social Security system for the majority of Social Security benefits. But proposals for small accounts will not allow low- and middle-income workers to accumulate real wealth or achieve other objectives of reform. Individual accounts should be as large as feasible, ideally at least half of payroll taxes.

There Is No Free Lunch

Individual accounts will create a better, fairer, and more secure retirement system. But they cannot work miracles. They will provide higher retirement benefits than Social Security can pay. But they will not make everyone a millionaire. They will help solve Social Security's financial crisis and save taxpayers trillions of dollars over the long run. But there is no free lunch. There are short-term costs that will require tough choices by the president and Congress.

Although we should not minimize the difficulties of transition financing, it is also important to remember that the financing of the transition is a one-time event that will actually reduce the government's future liabilities. The transition moves the government's need for additional revenue forward in time, but—depending on the transition's ultimate design—it will not increase the amount of spending necessary. In effect, it is a case of ''pay a little now or pay a lot later.''

82978$$CH4 12-08-04 07:30:47

Cato's Social Security Plan

- Individuals would be able to privately invest **6.2 percentage points** of their payroll tax through individual accounts. People who choose to do so will forfeit all future accrual of Social Security benefits.
- Individuals who choose individual accounts will receive **a recognition bond** based on past contributions to Social Security. These zero-coupon bonds will be offered to all workers who have contributed to Social Security, regardless of how long they have been in the system but will be offered on a discounted basis.
- Allowable investment options for individual accounts will be based on a three-tiered system: a centralized, pooled collection and holding point; a limited series of investment options with a lifecycle fund as a default mechanism; and a wider range of investment options for individuals who accumulate a minimum level in their accounts.
- At retirement, individuals will be given an **option of purchasing a family annuity or taking a programmed withdrawal.** Those two options will be mandated only to a level required to provide an income above a minimum level. Funds in excess of the amount required to achieve this level of retirement income can be withdrawn in a lump sum.
- If individuals accumulate sufficient funds in their accounts to allow them to purchase an annuity that will keep them above a minimum income level in retirement, they will be **able to opt out** of the Social Security system entirely.
- The remaining 6.2 percentage points of payroll taxes will be used to pay transition costs and to fund disability and survivors' benefits. Once, far in the future, transition costs are fully paid for, this portion of the payroll tax will be reduced to the level necessary to pay survivors' and disability benefits.
- The Cato plan is offered in the context of payable Social Security benefits. That is, the Social Security system will be **restored to a solvent pay-as-you-go basis** prior to the development of individual accounts. Workers who choose to remain in the traditional Social Security system will receive whatever level of benefits Social Security can pay with existing levels of revenue. The best method for accomplishing this is to change the initial benefit formula from wage indexing to price indexing.

82978$$CH4 12-08-04 07:30:47

Conclusion

Social Security reform is not an option—it is a necessity. Every two-year election cycle that Congress waits to address Social Security drives up the ultimate price of reform by roughly $320 billion. Polls show that the American people are ahead of their political leaders in being willing to address the need for fundamental change. It is time for Congress to act.

Suggested Readings

Biggs, Andrew. ''Perspectives on the President's Commission to Strengthen Social Security.'' Cato Institute Social Security Paper no. 27, August 22, 2002.

Ferrara, Peter, and Michael Tanner. *A New Deal for Social Security*. Washington: Cato Institute, 1998.

Piñera, José. ''Empowering Workers: The Privatization of Social Security in Chile.'' *Cato's Letters* no. 10, May 1996.

Tanner, Michael, ''The 6.2 Percent Solution: A Plan for Reforming Social Security.'' Cato Institute Social Security Paper no. 32, February 17, 2004.

Tanner, Michael, ed. *Social Security and Its Discontents: Perspectives on Choice.* Washington: Cato Institute, 2004.

—Prepared by Michael Tanner

82978$$CH4 12-08-04 07:30:47