

# Cato Handbook for Policymakers

**CATO**  
INSTITUTE

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## 17. Social Security

### **Congress should**

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

Although President Bush failed in his efforts to reform Social Security, the problems facing our national retirement system have not gone away. In fact, since the demise of the Bush proposal, Social Security's long-term unfunded liabilities have increased by more than \$550 billion, and now total \$15.3 trillion. Congress's failure to act is threatening America's economic stability and promises to bury our children and grandchildren under a mountain of debt. Reform is not an option, but a necessity, and Congress should act now.

But all Social Security reforms are not equal. Both raising taxes and cutting benefits have their own economic costs, and they make a bad deal even worse for today's younger workers. However, 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;
- increase national savings and economic growth;
- 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.

## The Financial Crisis

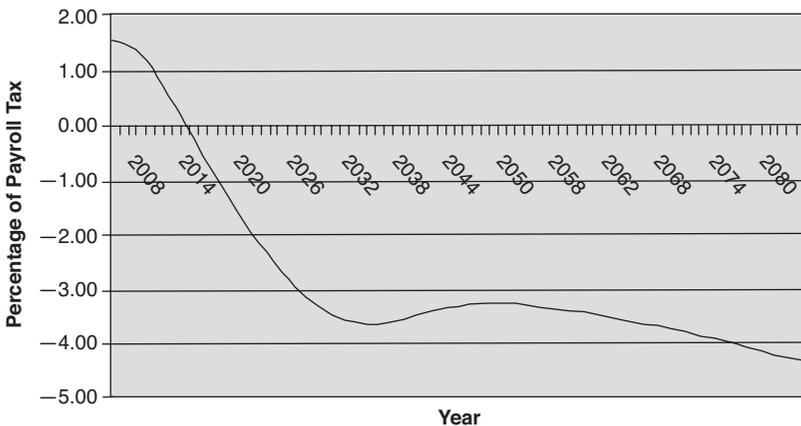
Social Security as we know it is facing irresistible demographic and fiscal pressures that threaten the future retirement benefits of today’s young workers. Although Social Security is currently running a surplus, according to the system’s own trustees, that surplus will turn into a deficit within the next nine years. That is, by 2017, Social Security will be paying out more in benefits than it takes in through taxes. (See Figure 17.1.)

In theory, Social Security is supposed to continue paying benefits after 2017 by drawing on the Social Security Trust Fund. Furthermore, the trust fund is supposed to provide sufficient funds to continue paying full benefits until 2041, 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,

**Figure 17.1**  
**Current and Projected Social Security Payouts, 2008–80**



SOURCE: The 2008 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

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 2041. At that point, Social Security will need to rely solely on revenue from the payroll tax—but that revenue will not be sufficient to pay all promised benefits. Clearly, Social Security is not sustainable in its current form.

And there are really few options for dealing with the problem. This is not an opinion shared only by supporters of individual accounts. As former President Bill Clinton pointed out, the only ways to keep Social Security solvent are to (1) raise taxes, (2) cut benefits, or (3) 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.

## **A Declining Rate of Return**

Yes, you could raise taxes and cut benefits enough to bring the system into solvency. That's what Congress has always done in the past. But this time, the tax increases or benefit cuts would have to be enormous. Besides, Social Security taxes are already so high, relative to benefits, that Social Security has quite simply become a bad deal for younger workers, providing a low, below-market rate of return.

This poor rate of return means that many young workers' retirement benefits are far lower than if they had been able to invest those funds privately. However, 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 basis, with almost all the incoming funds being immediately paid out to current beneficiaries. This system displaces private, fully funded alternatives under which the incoming funds 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.

## **Help for 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 Social Security can pay. And that does not take into account the fact that blacks, other minorities, 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 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 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 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 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.

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. However, the 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 was 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 or 401(k) plans. Their retirement benefits would not depend on the whims of politicians.

## 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 these 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 the following simple rules.

### 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. A successful Social Security reform will of course result in a solvent system, not just in the short run, but sustainable over time as well. But 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.

### Size Matters

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, continuing to rely on the existing pay-as-you-go Social Security system for the majority of Social Security benefits. But small account proposals 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 create 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.

Some people say that current budget deficits make Social Security reform, and 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 form of revenue to protect current retirees. But given Social Security’s unfunded liabilities, the transition does not really represent a new cost. It just makes explicit an already implicit debt.

Of course, it would mean paying that debt now rather than later. It is true, therefore, that 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. Sure you must pay the points up front, but you save money in the long run.

Although we should not minimize the difficulties of transition financing, it is also important to remember that financing the transition is a one-time event that actually serves to 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 would not increase the amount of spending necessary. In effect, it is a case of “pay a little now or pay a lot later.”

### **Cato’s Social Security Plan**

- Individuals would be able to privately invest **6.2 percentage points** of their payroll tax through individual accounts. Those 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 the individual accounts will be based on a three-tier 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 within 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 plan should be considered 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** before 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. The best method for accomplishing this is to change the initial benefit formula from wage indexing to price indexing.
- The Social Security Administration has scored Cato's plan as restoring Social Security to permanent sustainable balance. Indeed, while the transition would initially increase Social Security's short-term deficits, the program would begin to run a permanent surplus by approximately 2048.

## Conclusion

Social Security is not sustainable without reform. Simply put, it cannot pay promised future benefits with current levels of taxation. Yet raising taxes or cutting benefits will only make a bad deal worse. At the same time, workers have no ownership of their benefits, and Social Security benefits are not inheritable. This is particularly problematic for low-wage workers and minorities. Perhaps most important, the current Social Security system gives workers no choice or control over their financial future.

It is long past time for Congress to act.

### **Suggested Readings**

- 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.
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- , ed. *Social Security and Its Discontents: Perspectives on Choice*. Washington: Cato Institute, 2004.
- . “A Better Deal at Half the Cost: SSA Scoring of the Cato Social Security Reform Plan.” Cato Institute Briefing Paper no. 92, April 26, 2005.

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# CUTTING FEDERAL DEPARTMENTS AND PROGRAMS

