

## INTERGENERATIONAL TRANSFERS AND SUPER IRA'S

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Social Security, including Medicare, accounts for over 50 percent of federal domestic outlays, and almost one-third of total federal spending. National defense and debt interest expenditures, when coupled with Social Security payments, account for about 70 percent of total federal spending. Clearly, the size and scope of the federal government will never be substantially reduced without addressing Social Security.

The huge amounts of federal spending through Social Security should be especially troubling because, of all federal programs, it has the clearest, most widely utilized, private sector alternatives, including pensions, Individual Retirement Accounts (IRAs), life insurance, and health insurance. As Milton Friedman has long argued, there is no reason why all the functions of Social Security must be performed in the public sector.<sup>1</sup> It is indeed a truly radical departure from a private, free market economic system to require almost all Americans to rely on the government for the bulk of their income for a major portion of their lives—their retirement.

Given the huge size and scope of Social Security, the program has now become one of the foremost restrictions on economic freedom in American life. The maximum annual Social Security tax, including both employer and employee shares, has grown from \$60 in 1949, \$189 in 1958, and \$348 as late as 1965, to \$6,006 today, and it will be almost \$8,000 by the end of the decade. Requiring today's workers to invest so heavily for their retirement and insurance protection only through Social Security deprives them of the freedom to control major portions of their own income, and significantly limits their freedom to enjoy the fruits of their own labor.

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<sup>1</sup>See, for example, Friedman (1962, p. 182).

Fundamental reform of Social Security must become a primary concern for market-oriented policymakers. This paper examines why the case for such reform should now have broad public appeal. It also advances a politically appealing reform approach that should have substantial prospects for success. Finally, transition issues involved in the privatization of Social Security are discussed.

## The Case for Fundamental Reform

The compelling case for fundamental reform of Social Security arises from the overwhelming problems of the program. The most important of these is just now starting to be recognized. Although the program is still a relatively good deal for today's elderly, it has become a very poor deal for today's young workers, given the enormous tax burdens they now face over their working years. Even if these young workers receive all the benefits promised to them by Social Security today, they will still be receiving low, below-market returns, in many cases negative, on taxes paid into the program.

This problem is not a chance development, but a natural, inevitable result of Social Security's fundamental structure and operation. Social Security is said to operate on a pay-as-you-go basis. That is, the taxes paid into the program today are not saved and invested to finance the future benefits of today's young workers, but instead are immediately paid out to finance the benefits of current beneficiaries. The taxes of the next generation of workers are to be used to finance the benefits promised today's workers.

In the early years of Social Security, workers and their employers only had to pay the program's taxes for a few years before retirement. The tax burden in those years was also quite low, as we have noted. But because the program operates on a pay-as-you-go basis, the benefits paid to these early retirees were not limited to what could be paid based on the past taxes paid by them and their employers; rather, they were paid full benefits out of the taxes paid by those still working. Such benefits consequently represented a high return on the taxes they and their employers did pay.

Over time, however, the rate of return naturally began to fall as workers and their employers began paying higher taxes for more of their working years. For today's retirees, the program's benefits still represent above-market returns on taxes paid into the system. But, as noted, today's young workers and their employers must pay taxes of several thousand dollars a year into the program for their entire careers. These workers no longer enjoy any of the beneficial aspects of the start-up phase of the program. Instead, since no investments

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are made through the pay-as-you-go system, these workers lose the full market returns they could earn if their funds had been privately invested. The pay-as-you-go system can only pay returns to the extent tax revenues are increased over time, and such returns simply cannot keep up with private capital market returns. For most young workers entering the work force today, the real rate of return offered by Social Security under current law is less than 1 to 1.5 percent. For many two-earner couples and single workers, who will predominate in this generation, the Social Security rate of return is close to zero or even negative.<sup>2</sup>

An examination of stock returns from 1926 (when data were first compiled) to 1985 indicates that the composite real rate of return on all stocks on the Standard and Poor's 500 was 6.6 percent. The composite real rate of return on smaller company stocks on the New York Stock Exchange was even higher, at 9.3 percent.<sup>3</sup> If young workers entering the work force today could invest all their Social Security tax money, including the employer's share, in IRAs and earn a 6 percent real rate of return, which is somewhat less than the average return earned in the stock market over the last 60 years, most would receive three to six times the retirement benefits promised under Social Security, while at least matching the other types of benefits provided by the program. At a 4 percent real return, most would receive two to three times the retirement benefits promised by Social Security.<sup>4</sup> Besides these higher benefits, the system of private market investments supporting them would also generate substantial additional tax revenues to finance other government goods and services or general tax reduction.<sup>5</sup> Social Security generates no revenues for these purposes.

Moreover, whether Social Security can pay even the inadequate returns and benefits promised to young workers under current law remains questionable. Under the Social Security Administration's own most widely cited (intermediate) Alternative IIB projections, if we add all of the program's trust funds together and assume any can draw from the others as needed, then the entire combined program (OASDHI) runs short of funds by 2026, just before those entering

<sup>2</sup>See Ferrara and Lott (1985) and Ferrara (1986) for a more thorough discussion of these issues.

<sup>3</sup>Both statistics are from Ibbotson Associates (1986, Exhibit 10A, p. 45).

<sup>4</sup>Ferrara (1986).

<sup>5</sup>These revenues result from taxation at the corporate or business level on the full, before-tax rate of return produced by the private system's capital investments. Such taxation results from the corporate income tax, state and local taxes, and numerous other taxes. For further discussion, see Ferrara and Lott (1985); Ferrara (1986).

the work force today will be retiring. By 2035, the program's total expenditures would be almost 50 percent greater than total revenues each year.<sup>6</sup> Paying all the benefits promised to today's young workers under these projections would require a total Social Security payroll tax rate, including both employee and employer shares, over 23 percent, compared with 14.3 percent today.<sup>7</sup>

The Alternative IIB assumptions, however, may be overly optimistic.<sup>8</sup> Many independent observers believe that the Social Security Administration's so-called pessimistic Alternative III assumptions are more realistic.<sup>9</sup> These assumptions are certainly at least quite plausible.

Under the Alternative III projections the entire, combined program runs short of funds sufficient to pay full benefits by 1998. By 2035, when those entering the work force today will be in retirement, Social Security's total annual expenditures would be two and one-third times more than annual revenues.<sup>10</sup> Paying all the benefits promised to today's young workers would require an astounding Social Security payroll tax rate of over 37 percent.<sup>11</sup> This would mean a total Social Security annual tax, split between employer and employee, of \$7,500 for a worker earning \$20,000.

The Social Security payroll tax is already too high, seriously hampering economic growth and limiting job opportunities for today's young workers. To the extent this tax is borne by employers, it discourages them from hiring; to the extent it is borne by employees, it discourages them from working. Either way, the result is less employment and therefore less total output. The payroll tax is nothing more than a tax on employment, and, here as elsewhere, the result of taxing something is that there is less of it.

As noted above, the maximum annual Social Security tax is over \$6,000 this year, and by the end of the decade it will be almost \$8,000. For at least half of all workers covered by Social Security, the combined payroll tax is more than they pay in federal income tax.<sup>12</sup> In 1985 payroll tax revenues, drawn primarily from low and moderate

<sup>6</sup>All of these projections are calculated from Ballantyne (1985); Social Security Administration (1985a); Social Security Administration (1985b).

<sup>7</sup>Social Security Administration (1985a, Appendix E).

<sup>8</sup>See Ferrara (1985, chaps. 2 and 3) for a more thorough discussion of the optimism behind these assumptions.

<sup>9</sup>See, for example, Ricardo-Campbell (1984); Robertson (1985); Roberts (1985); Peterson (1982); Capra, Skepaldas, and Kubarych (1982).

<sup>10</sup>Calculated from the sources cited in footnote 6.

<sup>11</sup>Social Security Administration (1985a, Appendix E).

<sup>12</sup>Bridges (1981).

income workers, were over 70 percent greater than total federal corporate and indirect business tax revenues.<sup>13</sup> A married worker with two children earning \$7,700 this year will pay about \$550 in payroll taxes, with another \$550 from his employer that probably comes out of his wages as well, before paying a dime in federal income taxes. In a society deeply concerned about employment opportunities, this tax burden on employment is ludicrous. Yet, without fundamental reform the future probably holds in store only further payroll tax increases.

Social Security may also harm the economy by substantially reducing national savings. Though a fierce debate has raged in the academic community over the impact of Social Security on national savings in the past,<sup>14</sup> the program's negative impact on national savings today should be readily apparent. Social Security forces workers to provide for retirement through a pay-as-you-go system, which provides no savings to the economy. Whether this has a negative effect on savings depends on how workers would provide for their retirement in the absence of Social Security. To the extent workers would rely on intergenerational transfers from their children, then Social Security would have no negative effect on savings, as it would merely be replacing a private pay-as-you-go system that involves no savings with a public one. But to the extent workers would provide for their retirement through savings during their working years, then Social Security would be reducing savings, by replacing a private system that adds to the nation's savings with a public system that does not.

It is clear that workers today supplement Social Security primarily through private sector savings plans, such as pensions, IRAs, 401Ks, Keoghs, and insurance policies, rather than through voluntary support from their children. Indeed, today's workers are having fewer children per capita than at any time in history, indicating that children are not viewed as an essential or primary means of retirement support. Consequently, Social Security appears to be primarily substituting for private savings vehicles, and reducing national savings accordingly. Given the huge size of Social Security, this impact of the program in reducing national savings could be quite large. *Less saving means in turn less capital investment, fewer new jobs, and slower economic growth.*

In addition, the Social Security benefit structure is riddled with inequities that render the program unsuitable to our modern

<sup>13</sup>Council of Economic Advisors (1986).

<sup>14</sup>See Ferrara (1980, chap. 3; 1982, chap 3; 1985, chap. 4) for discussion of this debate.

pluralistic society. Workers are not paid equal returns on past taxes paid into the program. In particular, the program pays discriminatorily lower returns to two-earner couples, workers without children, and single workers. Blacks and other minorities with below average life expectancies also tend to receive lower returns on this account because they live fewer years in retirement, yet they are subject to the same taxes throughout their working years. A white male at birth today can expect to live 50 percent longer in retirement than a black male, and therefore receive 50 percent more in retirement benefits. Moreover, blacks as a group are significantly younger than whites, and since Social Security offers a worse deal to younger workers, the program disadvantages blacks on this account as well.

The problems with Social Security that most disturb market-oriented policymakers would also be important to many members of the general public. Those who wish to see a smaller federal government burden on society will recognize that this cannot be accomplished without reforming Social Security. As the private alternatives to Social Security continue to grow robustly, more people will question why workers must be forced to invest so heavily only through Social Security. As the payroll tax continues to grow past its already Olympian proportions, more and more workers will resent the restrictions on economic freedom involved in the program. Taken together, these and other problems of Social Security add up to a truly compelling case for fundamental reform.<sup>15</sup>

### Super IRAs: A Populist Proposal

Fundamental reform of Social Security does not require imposing sacrifices on the elderly. Quite the contrary, appropriate reform would strengthen Social Security and assure today's elderly their benefits, while providing new opportunities for today's young workers to enjoy a more secure and prosperous retirement, and to work in a more healthy economy today.

This can be accomplished by giving workers the option of substituting expanded "Super" IRAs for at least part of their Social Security coverage to start. A Super IRA option would allow workers to contribute additional amounts to their IRAs, up to some reasonable initial limit. In return for these contributions, workers would receive a 100 percent income tax credit equal to the amount of such contributions. That is, workers would receive a full dollar off their income taxes for every dollar they contributed to the Super IRA. Employers would

<sup>15</sup>See Ferrara (1980, 1982, 1985) for further discussion of these and other problems.

be allowed to make some or all the contributions on behalf of the worker, and take the tax credit accordingly.

Workers who exercise this option would then have their future Social Security retirement benefits (OASI) reduced to the extent they did so. For example, a worker who contributed an amount to his Super IRA each year for his entire career equal to 20 percent of his Social Security retirement taxes (OASI) would have his retirement benefits reduced by 20 percent. But the accumulated funds in the Super IRAs would pay benefits that would likely exceed the forgone Social Security benefits, leaving workers with higher benefits overall.

Later, the Super IRA option could be expanded. Workers and their employers could be allowed to contribute additional funds to their Super IRAs for the purchase of private life insurance, again in return for 100 percent income tax credits. To the extent each worker did so, if he died before age 65 his survivors would receive the private life insurance benefits rather than Social Security survivors insurance benefits. Workers and their employers could also be allowed to contribute additional funds for the purchase of private disability insurance, again in return for full income tax credits. To the extent each worker did so, he would receive the private disability insurance benefits in the event of disability in lieu of Social Security disability benefits. Similarly, workers could be allowed to contribute additional funds to their Super IRAs for the purchase of private medical insurance in retirement to substitute for Medicare. Ultimately, each worker would have complete freedom to choose how much to rely on the Super IRAs and how much on Social Security.

The purpose of the 100 percent tax credits is, in effect, to give workers their money back to the extent they agree to forgo future Social Security benefits and rely on their own Super IRAs. But it is crucial to recognize that the tax credits are taken against income taxes, not the payroll taxes that finance Social Security. Therefore, Social Security payroll tax revenues would not be reduced in any way, and would continue to flow into the program in full to finance benefits for today's elderly. The Super IRA option would simply result in a loss of income tax revenues.

The option could begin quite small to avoid a substantial loss of revenue, and then be slowly expanded. The revenue loss would eventually be offset completely by reduced Social Security expenditures, as workers relied more on Super IRAs and less on Social Security. Long before this point, moreover, the revenue loss could be eliminated on net due to new revenues generated from increased investment through IRAs. In addition, from the beginning there would be increased savings through the Super IRAs equal to the

amount of the temporary net revenue loss, since the tax credits are only allowed for Super IRA savings.<sup>16</sup> So even if the government had to borrow entirely to cover the temporary net revenue loss, there would be no net increase in the government borrowing drain on private savings.

Social Security itself would be greatly strengthened by such reform, improving the ability of the program to pay promised benefits. This is because while the program's payroll tax revenues are maintained in full, the program's expenditures in the future would be reduced substantially as workers relied more on Super IRAs than on Social Security. If the Super IRA option were expanded rapidly enough, the long-term financing problems of the program could be eliminated, even under pessimistic assumptions. Indeed, with the Super IRA option eventually expanded to the maximum, Social Security expenditures would likely be reduced dramatically, allowing room for sharp reduction in payroll tax rates.

Workers could always choose to rely entirely on the strengthened Social Security system. There would be no reduction in Social Security benefits for such workers, or for today's elderly. But those workers who did opt for the Super IRAs could expect much higher retirement benefits. These benefits would also be completely equitable, with each worker receiving back what he and his employer paid in, plus market investment returns, on an actuarial basis. The Super IRA benefits, moreover, would be financed on a fully funded basis, which would secure them against the financial instability inherent in Social Security's unfunded pay-as-you-go system.

Workers would also have much greater freedom of choice and control over their own incomes through the Super IRAs. Although workers would still be required to provide for their retirement and insurance contingencies through some means, the Super IRAs would allow them to choose and control the investments and insurance purchases to satisfy these requirements. Workers would consequently be able to tailor individual packages of investments and insurance coverage to suit personal needs and preferences. Further,

<sup>16</sup>To minimize the danger of a mere shifting of existing savings into Super IRAs, workers should be prohibited from withdrawing before retirement any Super IRA contributions for which a credit was received, and associated returns. Workers could not then shift existing savings held for nonretirement purposes into Super IRAs, as such savings once contributed could not be used for nonretirement purposes. Because Social Security benefits would be reduced for credited Super IRA contributions, the Super IRA savings would be needed to replace those lost benefits, and therefore would not be available to perform the purposes of other retirement savings. As a result, any shifting of existing savings into Super IRAs should be negligible.



workers could choose their retirement age after the 59 ½ minimum age for IRA benefits under current law. They could also choose to leave some of their Super IRA funds to their heirs, which they cannot do with Social Security. Super IRAs in addition allow workers instantaneous vesting and maximum portability. With its individualized flexibility and enhanced personal freedom, the Super IRA option along with Social Security is clearly an overall system far better suited to our rapidly changing, highly mobile, highly diverse, modern society than the rigid, 1930s-oriented Social Security system alone.

The reform would also have important benefits for the economy. National savings could be sharply increased through the funds paid into Super IRAs, with a fully expanded Super IRA option potentially producing hundreds of billions in increased savings each year. Such a savings increase would in turn produce new jobs and increased economic growth. Eventual payroll tax reductions would also stimulate job creation and economic growth.

The reform would also create new opportunities for the poor, because it would give them control over some capital through their Super IRAs. If a lifelong minimum wage earner and his employer could pay into a Super IRA what would otherwise be paid into Social Security, then, at the same returns that have historically been earned in the stock market, he would accumulate almost \$300,000 in today's dollars by retirement, even while providing for the preretirement survivors and disability benefits provided by Social Security.<sup>17</sup> This fund could pay him, out of continuing returns alone, more than he is currently offered under Social Security, and the fund would provide a solid foundation for the economic advancement of his children.

The Supplemental Security Income (SSI) program would continue to provide means-tested, general revenue financed welfare benefits to the elderly poor, ensuring that retirement income would not fall below a basic minimum. A substantial portion of benefits paid through Social Security today may be considered welfare benefits, as they are not based on past tax payments into the program, but on certain criteria thought to indicate need. Because Social Security benefits are paid without a means test, however, this welfare assistance goes to many who are not in need. But the more workers rely on Super IRAs, the more welfare assistance will be paid only through the means-tested SSI program, channeling welfare benefits only to those who are actually poor and eliminating the current substantial waste of welfare benefits paid through Social Security.

<sup>17</sup>See Ferrara and Lott (1985); Ferrara (1986).

In addition, the more workers across the whole economy are allowed to accumulate assets in their Super IRAs in lieu of Social Security, the more equal the national distribution of wealth would become. This is because workers would be accumulating substantial assets in their IRAs more equally distributed than the current distribution of wealth. If all workers paid into Super IRAs rather than Social Security, the national concentration of wealth would be reduced by one-third.<sup>18</sup> This would be achieved not by redistributing existing wealth, but by providing for the creation of new wealth equally distributed. Through the private IRA investments, each worker would develop a substantial ownership stake in America's business and industry. This could revolutionize political attitudes. Instead of retirees developing a psychology of dependence on big government, as with Social Security, they would tend to support the new foundation of their livelihood—private enterprise and free markets—as would average workers watching their stake in the private economy grow.

Finally, the reform would sharply reduce spending, as workers began relying more on Super IRAs than on Social Security. With a complete option to rely on Super IRAs, federal spending could potentially be reduced by more than one-fourth. No other single reform offers the potential for such a dramatic reduction in federal spending without all the pain of benefit cuts, but rather simply through the individual choice of workers.

It should be emphasized that the entire Social Security monolith need not be taken on all at once. Each of its components could be addressed separately through the Super IRA concept, with the complete option available only after many years. For example, reform could begin with the Social Security survivors insurance program. Social Security pays \$10 to \$15 billion annually in benefits to the survivors of young workers. Through these benefits, the government is simply preempting much of the private life insurance market, forcing workers to "buy" their life insurance from Social Security through payroll taxes.

A simple proposal could be advanced doing nothing more than allowing workers and their employers the option of contributing extra funds to IRAs to purchase private life insurance in return for tax credits. To the extent each worker exercised this option, his survivors (if he died before age 65) would rely on the private insurance rather than Social Security survivors' insurance. Expenditure reductions offsetting the short-term revenue loss would occur quite rapidly under this option. The survivors of workers who exercised the option

<sup>18</sup>See Feldstein (1976a).

in the first year and died in that year would rely on the private insurance benefits rather than Social Security, thereby reducing the program's expenditures. The short-term revenue gap could, as a result, be eliminated on net in less than a decade.

Alternatively, reform could focus initially on the chaotic Social Security disability insurance program. Government studies in 1979 indicated that 20–30 percent of the program's disability beneficiaries were, in fact, not disabled. In 1980, Congress mandated a review of each beneficiary's case. When the Social Security Administration started cutting off ineligible beneficiaries, however, a tremendous political outcry developed. The ensuing backlash was aided considerably by bureaucratic ineptitude, as the government appeared incapable of focusing its termination notices solely or even primarily on the 20–30 percent who were actually not disabled. In the face of the outcry, Congress backed down and stopped the reviews, and put most of the terminated beneficiaries back on the rolls.

This episode illustrates that the government cannot run a disability program because the decision as to who is disabled becomes too politicized. These decisions can only be made objectively in the private market by insurance companies subject to competition. Companies that are too lax in accepting disability claims will have unnecessarily high costs and be unable to compete. Companies that are too harsh will develop bad reputations and lose business. A reform that merely allowed workers to buy disability insurance through their IRAs as a substitute for Social Security would consequently be attractive all by itself. Expenditure reductions offsetting the short-term revenue loss would again accrue rapidly, as with a survivors insurance option.

Similarly, a reform effort could focus initially only on Medicare, which suffers from enormous long-term financing problems. Under so-called intermediate projections by the Social Security Administration, by the time today's young workers retire there would only be enough payroll tax revenues to finance 40 percent of projected Medicare hospital insurance benefits. Under the so-called pessimistic assumptions, paying all the hospital insurance benefits promised to today's young workers would require a higher payroll tax rate than for all of Social Security combined today.<sup>19</sup>

An attractive reform could involve allowing workers and their employers to contribute additional funds to IRAs, in return for tax credits, with the funds to be used for medical expenses in retirement. The Medicare deductibles would then be increased for each worker

<sup>19</sup>Social Security Administration (1985a, Appendix E).

to the extent he exercised this option. With the tax credits taken against income taxes rather than payroll taxes, the long-term financing problems of Medicare could be eliminated. Expenditures would be reduced through the increased deductibles, and program revenues would be maintained in full. This financing problem would be solved, moreover, without cutting the program's benefits for today's elderly or raising payroll taxes for today's workers.

### Political Prospects

On our present course, Social Security will continue to provide nothing but trouble for market-oriented policymakers. It will stand as an uncuttable leviathan in the federal budget. Statists will continue to push for expansion of the system, leaving allies of the market on the defensive. Periodic financial crises will leave market partisans resisting inexorable payroll tax increases with nothing to offer as an alternative but politically disastrous benefit cuts. This is playing the Social Security issue on the home field of the Liberal Welfare State.

The Super IRA concept offers allies of the market the opportunity to break out of these defensive dilemmas and shift the Social Security debate to new ground. It avoids both cuts in the program's benefits for today's elderly and increases in the program's taxes for today's workers, and instead simply offers workers the freedom to choose a better deal in the private sector. This is precisely the grounds on which the public always accepts market-oriented policies.

The proposed reform should appeal especially to young workers, for the current system is such a poor deal for them. It would be particularly appealing to the politically conscious young, urban professionals ("yuppies"), who receive especially low returns from Social Security because of their higher than average incomes and the prevalence of single workers and two-earner couples among them.

The reform should also appeal to the elderly. It leaves their benefits completely intact and strengthens the financial foundations of the program. In addition, the opportunities created by the reform for today's young workers will also be important to the elderly, who are concerned about the legacy they will leave their children and grandchildren.

Assuring benefits for today's elderly while creating new opportunities for today's young workers precisely matches broadly held public opinions among both young and old regarding Social Security. Fealty to the Social Security system per se is nonexistent, except among a small band of statist ideologues. What both the young and old support are the promised benefits for today's retirees. Both young

and old are broadly open to the suggestion that there is a better way to do it for the future.

The proposed Super IRA concept provides a better way by expanding the Social Security framework to provide for a greater role for the private sector. It is a purely positive approach that increases the freedom and options of workers. It modernizes and liberalizes the current system. The benefits of the reform indeed are overwhelming in comparison with the short-term, temporary costs. The proposed Super IRA concept consequently offers a politically appealing reform approach that should have substantial prospects for success.

### Transition Issues

Some critics of the idea insist, however, that *shifting from* a public pay-as-you-go system like Social Security to a private, fully funded system like Super IRAs will never be politically feasible because of a so-called double-payment problem. They contend that the generation working during the transition period would have to pay for two retirements, by paying for its own through the private system, while continuing to pay benefits to those already retired on Social Security. But this argument inaccurately characterizes the nature and costs of such a transition.

Such a reform would involve an additional cost for the initial working generation only to the extent that the reform involves an increase in savings, and that is the same cost involved in any savings increase. Suppose starting next year workers were allowed to withdraw \$20 billion in Social Security taxes annually to save in private IRAs. Future Social Security benefits of these workers would be reduced in proportion to the reduction in their Social Security taxes, but the benefits for today's elderly would continue to be paid in full. The loss in revenue to pay the benefits of the currently retired would be equal to the increased savings in the IRAs. If the government simply increased its borrowing to cover this revenue loss and pay the benefits of today's elderly, there would be neither a net loss or increase in savings. At the same time, there would be no extra cost to the current working generation to pay for "two retirements," since the government borrowed the needed funds to continue to pay benefits to the current elderly.

If, however, the government covered the \$20 billion revenue loss by raising taxes or cutting other government expenditures, rather than by increasing borrowing, there would be a \$20 billion increase in savings. The cost of this savings increase would be \$20 billion in reduced present consumption due to increased taxes or reduced

spending. But this very same cost would be involved in any \$20 billion increase in savings no matter how it came about. Any \$20 billion increase in savings must, by definition, entail a \$20 billion reduction in present consumption.

This savings increase, moreover, brings the same long-term returns and increased production as any other savings increase. That is, the new \$20 billion in increased savings invested through the IRAs would generate increased production equal to the full before-tax rate of return to capital just like any other invested savings.

The cost of shifting from the pay-as-you-go system to a private fully funded system, whether in the private or public sector, is simply the cost of paying for the increased savings involved in the fully funded system. This cannot be characterized as paying twice for your retirement and, therefore, always involving a bad deal. Workers are paying for increased savings which involve benefits as well as costs. The benefits include the long-term returns and increased income resulting from the increased savings, as well as, in the case of a shift to the private sector, the other benefits of a private system. One clearly cannot determine a priori that the trade-off between these costs and benefits, inherent in any savings increase, will necessarily be perceived as a bad deal. How workers will perceive this trade-off depends on how they subjectively value and weigh such costs and benefits.

It should be recognized that shifting from a public pay-as-you-go system to a private fully funded system involves the same transition costs as shifting to a public fully funded system, that is, shifting to fully funded Social Security. But one would not say that fully funding Social Security involves "paying for two retirements." It simply involves paying for the increased savings to fund the system fully. Clearly, one cannot determine a priori that fully funding Social Security would always necessarily appear to be a bad deal. It depends on how workers value the short-term costs of paying for the increased savings versus the long-term returns and increased income resulting from such savings, as well as the other benefits of full funding, such as enhanced security.

Indeed, Martin Feldstein has argued for more than a decade that Social Security should be shifted from a pay-as-you-go system to a fully funded system in the public sector, precisely because he believes the long-term returns from the increased savings involved in the fully-funded system are clearly worth the short-term costs of paying for such savings.<sup>20</sup> Feldstein's position is directly the opposite of those who say that shifting to a private fully funded system will

<sup>20</sup>See Feldstein (1974, 1975, 1976b, 1976c, 1977).

always appear unattractive, since the transition costs of shifting to a fully funded system are the same whether the system is in the public or private sector. There are actually more benefits associated with shifting to a private-sector system than to a fully funded federal system, which should make it even more worthwhile.

Those who believe that the aim of public policy should be to increase savings are implicitly saying that the short-term costs of paying for the increased savings are well worth the long-term returns produced by such savings. For those who hold this view, it follows that shifting from Social Security to a private fully funded system is also well worth the costs.<sup>21</sup> Through such reform, whatever increase in savings occurs is produced with the same total costs and total benefits as any other savings increase of the same magnitude. Moreover, this reform produces, at no extra cost, many other benefits that result from performing the functions of Social Security through the private sector. The reform should therefore be the best and most beneficial method of producing any such savings increase deemed warranted.

Workers themselves have indicated that a shift from a pay-as-you-go system to a fully funded system can be perceived as well worthwhile, by carrying out just such a shift in the private sector retirement supplements to Social Security. Decades ago, the private sector itself operated primarily on a pay-as-you-go basis. When the elderly reached retirement, they depended on their children for direct support. Over the years, however, this practice has changed dramatically. Today, as we have noted, the predominant means for private retirement support is fully funded, savings-based vehicles, such as pensions, IRAs, 401Ks, Keoghs, insurance, and just plain private savings, with little direct financial support from children expected. For today's workers planning for their future retirement, this seems to be overwhelmingly so.

This transition in the private sector involved the same sort of transition as would be involved in shifting Social Security to a fully funded basis in the public sector or private sector. As incomes rose, workers who were supporting their elderly parents began also saving for their retirement, and expecting less retirement support from their own children. They perceived this change as a good deal, given all

<sup>21</sup>The only danger from this view is that the shift may produce more additional savings than is worthwhile. If Social Security itself is substantially reducing savings, however, then it is unlikely that the shift would produce more of a savings increase than deemed warranted. In any event, it is quite easy to reduce any savings increase resulting from the transition. The transition can be taken in smaller steps, or the government can increase its borrowing during the transition.

the benefits involved, despite the extra cost of the increased savings. The benefits included not only the higher returns and income and enhanced security workers could expect relying on such increased saving. Through such savings these workers also removed a major financial burden from their children, and gained increased independence and freedom for themselves in retirement—benefits which also would result from shifting from Social Security to a private, fully funded system. Obtaining all these benefits through increased private savings is one way workers have chosen to use their increased personal incomes over the years.

Social Security in effect has prevented this transition from occurring in the portion of retirement support under its domain. It has frozen workers into an outdated pay-as-you-go system, when their own actions indicate they would shift to a fully funded system.

One might ask if workers would find the savings increase involved in a transition from a public pay-as-you-go system to a private fully funded system worthwhile, why haven't they already increased savings, bearing the costs and reaping the rewards? The answer is that individual savers may not find the costs of increased savings worth the return they would individually receive, after the heavy burden of taxation on capital investment returns. But voters may still prefer collectively to bear the costs of increased savings in return for the full before-tax return to capital they would collectively enjoy as well as for the short-term economic benefits that may result from a general savings increase, such as improved economic growth or the creation of new jobs. The proposed Social Security reform involves just such a collective offer. Moreover, the voters would have all the other benefits of shifting Social Security to the private sector to consider with such an offer, which a single saver individually would not have. In addition, Social Security itself may be a distorting factor that has reduced saving. In this case, the transition to a fully funded private system may just involve restoring the savings which individual savers together would have preferred in the absence of Social Security.

It should be noted that all the transition costs of shifting the enormous Social Security system to a private fully funded system do not have to be imposed on one generation. If such a shift would involve too much of a savings increase for any one generation, the transition could be spread out over several generations. Only a portion of Social Security could be shifted to the private system in each generation. Alternatively, the entire system could be shifted and the government could borrow some of the funds to pay off the elderly during the transition, with the debt repaid by future generations. This would



reduce the savings increase produced by the initial generation and spread the burden of the total savings increase over future generations.

There is an additional cost that applies only to the initial working generation at the time of any transition from a public pay-as-you-go system to a private fully funded system. If this generation itself pays the full benefits to the elderly under Social Security at the time, rather than paying those benefits by borrowing, then under the current system this generation would itself have become entitled to full Social Security benefits. But in shifting to the private fully funded system, this generation would be giving up the Social Security benefits and relying on the benefits of the private system instead. For this first generation, therefore, the value of these forgone Social Security benefits must be subtracted from the overall benefits of the reform in evaluating whether the reform is attractive. This is again a cost of the transition that occurs only to the extent that the transition results in increased savings, with the initial generation itself paying for the benefits of the elderly at the time, rather than borrowing to pay such costs and offsetting the increased savings in the private fully funded system.

The loss of these benefits to the first working generation does not change the costs or benefits of the reform in the aggregate. The forgone benefits merely represent the elimination of a redistribution between two generations—the working generation at the time of the reform and the following generation—a redistribution rendered unnecessary by the retirement benefits of the new private system. The elimination of this redistribution does not reduce the increased production resulting from any savings increase produced by the reform. Nevertheless, the elimination of this redistribution results in an effective reduction in the overall benefits of the reform received by the first working generation. This raises the question of whether subtracting the value of these forgone Social Security benefits from the overall benefits of the reform would necessarily make the reform unattractive to the initial working generation.

Recognition of this additional cost does not change the analysis very much. Because for today's young workers and for all future generations, the returns under the private fully funded system will be higher—indeed very much higher—than under Social Security, workers in the initial generation would still on net get strong returns and substantial increases in income, as well as all the other benefits of the reform, in return for bearing the transition costs. Workers would still be getting more in return for paying more. Consequently, one still could not determine a priori that workers in the initial generation would necessarily find the reform unattractive.

Indeed, we can see just how much more the private system's returns and benefits would be. The full amount of benefits produced by the system of private investments is the before-tax, real rate of return to capital. This represents the full value of the increased production resulting from the private system's investments. Even if some of this return is taxed away, that just means some of the benefits are being used to purchase additional government goods and services or reductions in other taxes. The full amount of benefits produced by the private system still must be taken into account, even if some are provided in this form.

Martin Feldstein and others have estimated the full, real, before-tax rate of return to capital in the United States at around 12 percent.<sup>22</sup> This 12 percent return does not represent a return routinely available to individual investors, who receive the lower returns remaining after federal, state, and local taxes are paid. Some investment vehicles also shift some of the profit to others in return for reduced risk. But at least in theory, the tax and investment system could be arranged so that the full before-tax return to capital earned by retirement investments is entirely devoted to retirement benefits. Let us examine such a situation to see at least the significance of the difference between the full before-tax return to capital and the returns offered by Social Security to today's young workers.

As previously noted, for most of today's young workers the real rate of return offered by Social Security is less than 1 to 1.5 percent.<sup>23</sup> Benefits payable by a private fully funded system earning a 12 percent return would be more than 20 times greater than benefits payable by a Social Security system earning a 1.5 percent return.<sup>24</sup> Under these circumstances, even given that the initial generation of workers has to forgo Social Security benefits under the reform, they would still be receiving on net at least an additional 19 times Social Security benefits through the private system in return for bearing the transition costs of the reform.

Clearly, one cannot say a priori that workers would necessarily find this to be a bad deal. The value of the forgone Social Security benefits is quite small relative to the overall benefits of the reform. The loss of this redistribution could be seen as in effect a tax on the

<sup>22</sup>Feldstein (1974, 1975, 1976d); Stockfish (1982); Holland and Myers (1979); Gorman (1974).

<sup>23</sup>Ferrara and Lott (1985); Ferrara (1986).

<sup>24</sup>If one invests a certain sum each year in a system paying a 12 percent annual return, and invests an equal sum each year in a system paying a 1.5 percent annual return, after 45 years the total accumulated through the first system would be more than 20 times greater than the total accumulated through the second.

full investment returns of the private retirement system, a quite small tax compared with the huge tax burdens regularly applicable to private investment returns. Under any policy to increase savings, individual savers themselves would not be receiving the full benefits produced by their own savings, due to taxation and other factors.

Inevitably, the returns on the private retirement investments would be subject to some taxation. But this would result in the creation of new tax revenues not generated under the current Social Security system. These new tax revenues can be seen as offsetting at least some of the cost of paying benefits to the elderly during the transition. If we assume that one-third of the before-tax private investment returns would be taxed away each year under some tax-preferred retirement system, such as pensions or IRAs, then with all Social Security taxes invested in the private system each year, sufficient new revenues would be generated by taxation of the private system's investments to pay one-half of remaining benefit obligations to the elderly.<sup>25</sup> This would cut the transition cost for the initial working generation in half. At the same time, the workers in this generation would receive through the private system at least seven times the retirement benefits promised by Social Security.<sup>26</sup> Consequently, given that these workers would forgo one time Social Security benefits under the reform, they would still be receiving, in return for transition costs equivalent to 50 percent of Social Security taxes, on net at least an additional six times Social Security benefits through the private system.<sup>27</sup> In other words, under these circumstances the reform would mean that those in the first working generation would pay 50 percent more than under the current system but receive in total seven times the benefits.

<sup>25</sup>If the amount to be paid into Social Security were instead paid into the private system, with one-third of the before-tax return taxed away, then in less than 20 years there would be enough tax money generated each year to fund Social Security benefits completely. The tax funds, therefore, would pay more than half of the initial working generation's liability to the elderly over the generation's entire 40-years-plus work span.

<sup>26</sup>With one-third of the full 12 percent return taxed away, workers would receive a return of 8 percent on their retirement investments. If one invests a certain sum each year in a system paying an 8 percent annual return, and invests an equal sum each year in a system paying 1.5 percent annual return, after 45 years the total accumulated through the first system would be seven times greater than the total accumulated through the second.

<sup>27</sup>Since one-half of the benefit obligations to the elderly would be paid by the taxes generated by private investments, an amount equal only to 50 percent of the Social Security taxes otherwise to be paid by the initial working generation would be sufficient to pay off the rest of the benefit obligations of the elderly.

Moreover, because the benefits of the private system are potentially so high, workers and their employers could be allowed to save less each year for retirement through the private system than they would be required to pay into Social Security. They could, for example, be required to pay into the private system only one-half of what they would be mandated to pay into Social Security. With the same taxation of returns as indicated above, under these circumstances the private system would pay 3.5 times the benefits of Social Security and generate sufficient revenues to pay off 25 percent of benefit obligations to the elderly. After paying off all other remaining benefit obligations to the elderly as well as paying into the private system, the reform would mean that those in the first working generation would pay 25 percent more than under the current system, but receive in total 3.5 times the benefits.

It should be emphasized that the burden on the first working generation could always be reduced by several orders of magnitude, along with the benefits, by shifting only a small portion of Social Security to the private fully funded system. Further portions of the program could be shifted in later generations. Alternatively, in the context of complete reform, the government could again borrow some of the funds to pay off the elderly during the transition, with the borrowing to be paid off by future generations.

In addition, besides the higher monetary benefits offered by a shift from the public Social Security system to a private fully funded system, there are many other important benefits resulting from such reform that also must be weighed by the initial working generation. To begin with, the reform would replace the current pay-as-you-go Social Security system, plagued with major long-term financing problems creating great uncertainty, with a private system which would be far more secure because it is fully funded. The reform would also replace the haphazard, inequitable benefit structure of the current system with completely equitable private benefits offering each worker the same market returns. Workers would also have much greater freedom of choice, independence, flexibility, and control over their own incomes through the private system. As we have noted, they would be able to tailor individual packages of investments and insurance coverage to suit their varying individual needs and preferences.

The reform is also likely to have substantial positive effects on the nation's economy. Any increase in savings would probably have beneficial effects beyond merely the newly generated income represented by the returns on the private investments. The more rapid economic growth produced by such a savings increase would reverberate throughout the economy, likely producing further economic

growth, new jobs, and increased employment in a supply-side boom. Eventual reductions in the payroll tax made possible by the reform would also stimulate greater economic growth, creation of new jobs, and higher employment.

Those in the initial working generation may also be expected to value the benefits of the reform for their children. The reform would remove an enormous burden for the children of the initial working generation, allowing them to participate freely in the private sector without extraneous obligations. Many would also value such continuing benefits for all future generations. If people are convinced that it makes much more sense to have a private system rather than Social Security, they will be willing to incur some costs over their lifetimes to set things right for the future.

Indeed, many in the initial generation will value a number of benefits of the reform which may be perceived ideologically. Those who favor limited government and reliance on free markets would find special value in the reform, as it would in effect "denationalize" the large portion of the pension and insurance industries now represented by Social Security, producing a major shift of economic functions from the public sector to the private sector, and sharply reducing federal spending in the process. Many will also value the new opportunities and increased income especially important and beneficial to the poor. Special value will also be seen by many in the broader distribution of wealth and broader ownership of private business and industry resulting from the reform.

The transition process itself is likely to produce some additional benefits. The need to raise funds during the transition to continue paying benefits to the elderly might pressure the government into cutting wasteful, unnecessary spending, or at least into restraining the growth of wasteful spending. Or it might pressure the government into selling off assets it would otherwise keep, releasing such assets to more productive uses in the private sector.

Finally, it must be recognized that the votes of only a majority of the initial working generation are necessary to approve the reform. Those especially sensitive to the above described advantages of the reform would provide the foundation of a pro-reform coalition. It is easy to see, for example, that those ideologically inclined to favor private markets and economic freedom would readily embrace such reform. Moreover, those who receive discriminatorily lower returns from Social Security would probably also join a proreform coalition. Banks, insurance companies, mutual fund companies, stockbrokers, and other financial institutions could also be expected to support it heavily. In addition, many voters might feel relatively immune to

any of the transition costs of change. Many might feel that they have the political clout to prevent any increase in their taxes or any cuts in government benefits crucial to them. These voters would also more readily support the reform. Such factors would ease the formation of a successful political coalition in favor of the reform.

Given the wide-ranging benefits and manifold social and political considerations, including many benefits that are purely subjective, it should be clear that one cannot possibly determine a priori that the reform will necessarily be perceived as a bad deal by the initial working generation. Indeed, changing Social Security to a public fully funded system would involve the same costs for the initial working generation as shifting to a private fully funded system. Yet, as we have noted, Feldstein believes that the benefits of such a transition are obviously worth the costs, and these benefits do not include all the advantages of shifting to the private sector. Moreover, the shift in the private sector over the years from pay-as-you-go mechanisms of retirement support, such as family transfers, to fully funded savings vehicles today involved the same costs for the initial working generations undertaking the change. Yet, their own actions indicate that they found the costs to be worth the benefits, and there were not as many benefits as would be involved in shifting from the public to the private sector.

The notion that the reform must be a bad deal stems from the misleading label, "paying twice for retirement," which skews consideration of proposals for reform. The correct label is "paying for the increased savings resulting from the reform," which leads to the realization that whether it is desirable depends on a subjective weighing of the costs and benefits by workers. Whether shifting to a private, fully funded system will be perceived as desirable can be determined only by offering it in the political marketplace and letting workers decide based on their subjective preferences.

Another transition issue is whether anything will be accomplished if, during the shift, the government simply borrows all funds needed during the transition to pay remaining benefit obligations to the elderly. Would Social Security's pay-as-you go system then simply be replaced by a similar tax and transfer scheme conducted under the auspices of explicit federal debt, with no new savings generated in the economy? Instead of paying taxes into Social Security, might workers then just be paying taxes to the government to service the debt, with Social Security benefits replaced by the interest on the debt?

First, even if the transition is financed 100 percent by borrowing, the reform still produces important breakthroughs. The borrowing

only explicitly recognizes a debt that already implicitly exists through Social Security—the benefits owed to workers and retirees, or, in other words, the unfunded liabilities of Social Security. The key factor is that these unfunded liabilities would no longer continue to grow as they would under Social Security. As workers start paying into the private system each year and as new workers join the work force paying into the private system, further unfunded liabilities would not be accruing under Social Security, as they would otherwise. Instead, workers would be accruing their additional benefits each year under the fully funded private system. If all workers and retirees opted for the private system on a certain day, with only Social Security benefits accrued as of that day to be paid in the future, then the present value of Social Security liabilities (or debt incurred to pay them off) discounted back to that day would always be the same fixed sum, whereas it would continue to grow if Social Security continued as is.

Over the long run, the reform would eventually generate increased savings on net, as growth in real wages and the working population led the savings accumulated in the private retirement system to grow past the value of old Social Security unfunded liabilities now held in explicit federal debt. The net increased savings would begin slowly and grow slightly each year. Over time, the total amount of the debt incurred to pay off Social Security liabilities would become less significant relative to the growing economy. The total amount of savings generated through the private system would never reach the limits it would have if the transition had not involved any borrowing, unless the federal debt representing such borrowing were paid off in the future. But over time, this difference would also become less significant.

Milton Friedman recognized this in proposing the privatization of Social Security in 1972.<sup>28</sup> He recommended that bonds be issued to all workers and retirees for the amount of their accrued benefit obligations under Social Security. These bonds would then be paid off out of general revenues when cashed in by the workers or retirees for their retirement benefits. The Social Security tax would be abolished immediately, and workers would provide for their retirement from that time onward through the private sector. Friedman argued that the bonds would merely be recognizing explicitly federal debt that already existed implicitly in the unfunded liabilities of Social Security. He contended that the proposed reform would end the accumulation of further benefit obligations under Social Security and

<sup>28</sup>Cohen and Friedman (1972).

allow the private sector to take over thereafter. In regard to all the transition issues we have discussed, Friedman's reform proposal is substantively the same as the Super IRA reform.

Second, and more important, the goal is not to finance the transition by borrowing. The goal is to finance it by as little borrowing as possible and to pay off in the future whatever borrowing is necessary. Only such a goal will phase in a truly privatized system as quickly and completely as possible. The proposed Super IRA reform, or any similar reform such as the one Friedman has proposed, makes it politically possible to achieve such privatization. The Super IRA reform in particular is a positive, attractive proposal politically. Once it is adopted, in order to complete privatization, politicians do not need to talk about privatizing Social Security or making it voluntary or doing anything in regard to Social Security. They only need to talk about reducing the relative size of the federal deficit and the growth of national debt. The issue is consequently changed from a risky subject politicians fear—overhauling Social Security—to a politically safe subject they routinely campaign on—federal deficits and the national debt.

During the transition under a Super IRA reform, a substantial portion of the continuing benefit obligations to the elderly will be financed by some means other than borrowing. The increased deficit due to the lost revenue resulting from the Super IRA option will lead to some spending reductions that would not have occurred otherwise, to the delay or forgoing of some other tax reductions that would have occurred otherwise, and possibly even to some tax increases that would not have occurred. Such results would naturally stem from routine pressures to maintain total deficit and national debt parameters. Even some such resulting spending reductions and revenue increases to pay the transition costs of the reform will cause the value of the explicit debt incurred to pay off Social Security liabilities to fall far below the trend line of continuing economic growth, rapidly depreciating the value and significance of such debt relative to the economy. Indeed, over the long run, routine political pressures on the total level of deficits and national debt are likely to lead them to return to historical levels as a percent of GNP. In the process, any borrowing to finance the Social Security privatization reform will have, for all practical purposes, been paid off. The Super IRA reform, therefore, charts a politically pragmatic route to Social Security privatization.

## Conclusion

The shackles of the welfare state will never be thrown off without addressing the nation's gargantuan social insurance system, includ-



ing Social Security and Medicare. Market-oriented policymakers must explore means and devise ways to achieve what is clearly the appropriate policy for such programs, that is, shifting their functions primarily to the private sector.

The proposed Super IRA reform is one means by which this can be achieved. Given the enormous problems of Social Security, such fundamental reform can now have broad appeal to the public. Presented properly, it can be politically attractive and ultimately successful.

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# FERRARA'S SUPER IRA PROPOSAL: A CRITIQUE

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There are things that are right and things that are wrong with Peter Ferrara's (1986) paper. In my comment I will discuss examples of both characteristics.

## Points of Agreement

### *Need to Examine the Total Program*

When Ferrara talks about Social Security, he correctly refers to both cash benefits and Medicare benefits. Too many analysts and commentators refer only to Social Security's cash benefits when they are reporting on its financial condition, but then refer to the entire program of cash benefits and Medicare benefits when they are talking about the wonders of Social Security. This practice accounts for most of the confusion about whether Social Security will have large deficits or large surpluses in the years ahead.

When we refer to Social Security, we should refer to the program of benefits that people can expect to receive in exchange for paying their Social Security, or FICA, taxes: old-age benefits, survivor benefits, disability benefits, and hospital insurance benefits provided under the Medicare portion of Social Security. These benefits are frequently referred to as OASDI and HI benefits. As analysts studying the appropriateness and viability of Social Security in the future, we should also include the Medicare Supplementary Medical Insurance (SMI) program, even though these benefits are financed by general revenue and premiums paid by participants, and not by the FICA taxes.

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A person who retires at age 65 receives monthly benefits under the Social Security program, made up of two parts: (1) A cash annuity, payable monthly for life, adjusted explicitly to reflect changes in the Consumer Price Index; and (2) A medical care annuity, payable monthly for life, the value of which increases implicitly as the cost of medical care increases. The medical care annuity is not paid in cash, but rather in kind—that is, in the form of medical care insurance protection. The approximate monthly value of this insurance protection for HI and SMI benefits can be determined from the annual Trustees Reports. Some examples of estimated average monthly annuities paid in 1985 are shown in Table 1.

For the retired worker alone, the medical care annuity of \$190 is 29 percent of the total annuity of \$662. For the retired worker and spouse, the medical care annuity of \$380 is 33 percent of the total annuity of \$1,160. (These examples are based on averages and ignore the differences in male and female per capita medical care costs.)

Medicare is thus a very important part of every retired person's benefits. A reduction in Medicare benefits may be even more burdensome to the beneficiary than a reduction in cash benefits, since it may be more difficult to replace benefits lost as a result of Medicare cuts than it is to replace reductions in cash benefits. So when we talk about Social Security and whether the benefits are appropriate, and whether we will be able to afford the benefits in the future, we should talk about the total program, not simply part of it.

#### *Social Security's Overwhelming Problems*

Ferrara makes another very important and, I believe, correct observation when he states, "Fundamental reform of Social Security does not require imposing sacrifices on the elderly" (p. 200). He says there is a compelling case for fundamental reform of Social Security because

TABLE 1  
SOCIAL SECURITY AVERAGE MONTHLY ANNUITIES, 1985

Monthly Annuity (\$)	Retired Worker over Age 65	Retired Worker and Spouse
Cash Annuity	472	780
Medical-Care Annuity		
HI	128	256
SMI	62	124
Total	<u>662</u>	<u>1,160</u>

SOURCE: Social Security Administration.

of the overwhelming problems of the program, and I believe he is correct.

To further bolster his case, Ferrara cites the irritatingly high present cost of Social Security and the unbearably high projections of future cost. The OASDI and HI parts of Social Security now cost about 14 percent of taxable Social Security earnings. By the time the baby-boomers retire, this cost could well rise to about 23 percent of such earnings under the Alternative II-B (*intermediate*) assumptions and over 40 percent of earnings under the Alternative III (*pessimistic*) assumptions. This projected increase would be in addition to the costs of the SMI program.

In my opinion, the Alternative III assumptions are the ones we should use to determine whether it seems reasonable to expect that future benefit promises can be fulfilled under the Social Security program—that is, whether future income will be approximately equal to future outgo. Another way to think of the future imbalance between scheduled tax income and benefit promises is this: under Alternative III assumptions, scheduled taxes would be enough to pay only about 50 percent of the Social Security benefits we have promised during the next 75 years. It is clear we have promised more than we can deliver.

In speaking of the political aspects of Social Security reform, Ferrara makes a very important point when he says (p. 206):

On our present course, Social Security will continue to provide *nothing but trouble for market-oriented policymakers*. It will stand as an uncuttable leviathan in the federal budget. Statists will continue to push for expansion of the system, leaving allies of the market on the defensive. Periodic financial crises will leave market partisans *resisting inexorable payroll tax increases with nothing to offer as an alternative but politically disastrous benefit cuts*. This is playing the Social Security issue on the home field of the Liberal Welfare State.

Experience to date certainly supports Ferrara's analysis of the political aspects of Social Security reform. Thus far, even the market-oriented Reagan administration, whose rhetoric favors individual responsibility and a reduction in the welfare state, has treated Social Security as a sacred cow.

## Points of Contention

### *Returns to Young Workers*

Ferrara believes that one of the reasons fundamental reform is necessary is that "Although the program is still a relatively good deal

for today's elderly, it has become a very poor deal for today's young workers" (p. 196). I agree that older workers got a better deal than younger workers will get (at least five times as good a deal). But the younger workers' deal may not be so bad as the author suggests and it may not be so bad as to require a fundamental reform.

Ferrara compares a young worker's Social Security benefits with alternative benefits he would receive by investing his and his employer's Social Security taxes privately and earning the "average return earned in the stock market over the last 60 years," and concludes that "most would receive three to six times the retirement benefits promised under Social Security, while at least matching the other types of benefits provided by the program" (p. 197). These calculations were based on a 6 percent real rate of return. I would suggest that it is not appropriate to assume that the average individual can earn a 6 percent real rate of return year in and year out for 50 years or so. Based on a real interest rate of about 2 percent, which somehow seems more credible, the generation of workers currently entering the work force will receive benefits that are roughly equivalent to their taxes, assuming no changes in scheduled taxes and benefits. (This comparison ignores Medicare benefits and taxes.)

The author acknowledges in his paper that "For most young workers entering the work force today, the real rate of return offered by Social Security under current law is less than 1 to 1.5 percent" (p. 197). I doubt that this is such a low rate of return for the new generation of workers that they will demand fundamental reform solely because of the low return. On the other hand the lack of individual equity within this generation could well result in dissent.

The question of whether individuals get their money's worth from their individual taxes is no more relevant to evaluating Social Security than it is to evaluating the public school system or the national defense program or the federal program of highways and bridges. The only reason people ask questions about return on investment under the Social Security program is the program has been misrepresented to them. Also, as Ferrara pointed out, there are private sector alternatives to most of Social Security's benefits but not to many of the other government programs.

Unfortunately, much of the rhetoric used to describe Social Security for the past 50 years has implied that there was a large degree of individual equity: that individuals were paying for their own benefits. Anyone who has studied our Social Security system knows that it is not based on equity among generations or within generations: that is, there is virtually no connection between what one pays in taxes and what one receives in benefits.

Equity is not essential to the operation of a social insurance system. Complete equity may not even be desirable; however, it cannot be long acceptable to provide significantly less equity than is represented to the public to exist. In other words, you cannot fool all the people all the time and that seems to be what the advocates of a "bigger and better" Social Security system have been trying to do.

*The Double-Payment Problem*

The author spends a large portion of his paper assuring the reader that the "so-called double-payment problem" involved in the transition from a pay-as-you-go system to an advance-funded system is not a real problem. He makes such statements as "there would be no extra cost to the current working generation to pay for 'two retirements' " (p. 207). After several pages of such reassurance, he finally admits, however, that "there is an additional cost that applies only to the initial working generation at the time of any transition from a public pay-as-you-go system to a private fully funded system" (p. 211); namely, that such generation would be paying for two retirements but receiving only the private retirement benefit and forgoing the public retirement benefit. Well, it is only this initial working generation that counts. No generation, particularly the current young generation, is going to knowingly and willingly sacrifice for the benefit of future generations. (A generation that questions the present Social Security system on the grounds of unfairness is unlikely to sacrifice for the benefit of a yet unborn generation.)

Ferrara minimizes this loss to the transition generation by relying on presumed extraordinary real rates of return to produce phenomenal benefits. For example, he states (p. 212):

Benefits payable by a private fully funded system earning a 12 percent return would be more than 20 times greater than benefits payable by a Social Security system earning a 1.5 percent return. Under these circumstances, even given that the initial generation of workers has to forgo Social Security benefits under the reform, they would still be receiving on net at least an additional 19 times Social Security benefits through the private system. . . .

Later in the paper the author assumes the individual will have part of his 12 percent return taxed away, leaving a net return of only 8 percent, which will result in private system benefits "at least seven times the retirement benefits promised by Social Security" (p. 213).

At the risk of sounding cynical, I will say that I have always been told that if something is too good to be true, it is probably not true. Real interest rates of the magnitude used variously throughout the

paper (first 6 percent, then 12 percent, and finally 8 percent) are too good to be true, in my opinion.

*Pitfalls of Super IRAs*

The author's proposal for Super IRAs would result in the loss of substantial income tax revenues (because of the tax credits granted). He presumes such a loss would be offset by reduced Social Security expenditures, new revenues generated by increased business activity associated with the savings attributable to the Super IRAs, and increased government borrowing (if all else fails). He dismisses the problem of lost revenues too easily, I believe. He states that any necessary additional government borrowing will be painless because of the added saving resulting from the Super IRAs. But this saving cannot be available for loans to the government; for if it is, it cannot generate the large investment returns in the private sector that he is relying on to make his reform proposals palatable.

It seems to me that the crux of Ferrara's proposal is that it will be better for the American public to have a system of retirement and related benefits that is based on individual equity instead of social adequacy, and to save in advance for those benefits, thus increasing the nation's pool of capital and the well-being of the populace. So far, so good. But then he uses assumptions that defy all reason about the investment return on the individual's accumulating retirement funds as well as the increased economic well-being of the entire population that will result from the increased pool of capital. The projected consequences, using these economic assumptions, do not assure me that Super IRAs are the panacea; rather, they tend to foster a suspicion that the proposals must be flawed or else such an optimistic and glowing account of the end result would not be needed to convince me of the merit of the proposals.

Many of the important statements in Ferrara's paper appear to be verified and amplified in the references mentioned in the footnotes; however, most of these references are to his own writings. The paper contains entirely too many unsubstantiated (and incredible) assertions to be considered a rigorous work.

His proposals seem to point in the right general direction, at least according to my own philosophy. Furthermore, they may be well thought out and may work in theory, but this is not evident from the material presented in the paper. It will be difficult for his proposals to be accorded a fair evaluation until:

- The proposals are formulated in more detail (particularly with regard to the large portion of Social Security benefits paid other



than upon normal retirement), and presented with more factual backup and less evangelical fervor;

- More realistic and credible assumptions are made about the economic consequences of providing retirement benefits by advance funding rather than a pay-as-you-go method;
- A more rigorous quantitative assessment is made of the consequences of shifting from a pay-as-you-go system to an advance-funded system, including the effect of the revenue reductions arising from the tax credits; and
- More specific transition proposals are formulated that recognize the difficulties posed by the “transition generation.”

## Conclusion

In addition to the reasons for Social Security reform given in the paper, there is another compelling reason that is perhaps the most important of all. The present Social Security program, with all its complexity and confusion about the benefits it provides, is changing our attitudes about our responsibility for saving and providing for our own future needs and those of our extended family. More and more people believe that their economic needs in time of adversity should and will be met by the government, that is, by someone other than themselves. This change in attitude about responsibility for self can have frightening long-range consequences.

The nation must decide the extent to which it wants its citizens to have freedom of choice and the extent to which it wants to regulate their activities. It can then design an appropriate public policy as to the optimum roles to be played by the three natural sources of retirement income: government, employers and trade unions, and individuals. By properly designing and implementing such a policy, the nation can insure that its citizens' basic economic security needs are met in ways that are consistent with the social and economic environment in which the nation will flourish, not wane. The challenge of finding and implementing the optimum mix that is the most favorable to this end is considerably greater than merely satisfying the population's economic security needs during the next few years.

There is no reason for this country to continue with a social insurance system that is controversial, constantly on the verge of financial collapse, out of phase with the times, and—in my opinion—doomed to ultimate failure. Living with such a system is an unnecessary drain on our collective productivity and psyche. It is eminently more sensible for us to design a social insurance system that is understood and perceived as fair and reasonable by the majority of citizens and

that will be considered an aid, rather than a hindrance, to the attainment of a healthy and productive national economy. Young innovative persons—such as Peter Ferrara—who are not afraid to advance new and untested ideas will surely lead us eventually to more rational solutions to all of our problems than we have yet discovered.

### Reference

Ferrara, Peter J. "Intergenerational Transfers and Super IRAs." *Cato Journal* 6 (Spring/Summer 1986): 195–220.