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Social Security Choice

SOCIAL SECURITY THIS WEEK

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Nobel Prize Winner Prescott Supports Private Accounts

Edward Prescott, winner of the 2004 Nobel Prize in Economics, discusses privatizing Social Security in a recent commentary in the *Wall Street Journal*. Prescott covers much ground in his commentary, noting the success of PRAs in other countries, the patronizing nature of the system, and the adverse effects of the system on the labor supply. He also notes that reform is necessary to separate out the welfare aspect of the program from the retirement savings aspect of the program. Both are necessary functions, he writes, but neither can work efficiently when combined. An excerpt of his commentary follows.

"Before I describe the benefits of such accounts, let's begin by dismissing the notion that individual savings plans are somehow dangerous to U.S. citizens. Some politicians have vilified the idea of giving investment freedom to citizens, arguing that those citizens will be exposed to risks inherent in the market. But this is political scaremongering. U.S. citizens already utilize IRAs, 401Ks, PCOs, Keoghs, SEPs and other investment options just fine, thank you. If some people are conservative investors or managing for the short term, they direct their funds accordingly; if others are more inclined to take risks or looking at the long run, they make appropriate decisions. Consumers already know how to invest their money—why does the government feel the need to patronize them when it comes to Social Security?

"It would be one thing if the government's Social Security system paid a decent return, but as the President's Commission reported, for a single male worker born in 2000 with average earnings, the real annual return on his currently-scheduled contributions to Social Security will be just 0.86%. And for a worker who earns the maximum amount taxed (then $80,400), the real annual return is a negative 0.72%. A bank would have to offer a pretty fancy toaster to get depositors at those rates of return.

"Further, about two dozen countries have reformed their state-run retirement programs, including Chile, Sweden, Australia, Peru, the U.K., Kazakhstan, China, Croatia and Poland. If citizens in these countries can handle individual savings accounts, especially citizens in countries without a history of financial freedom, then U.S. citizens should be equally adept. At a time when the rest of the world is dropping the vestiges of state control, the United States should be leading the way and not lagging behind.

"An important benefit of individual savings accounts is that they are transparent, and transparency solves many problems. For example, naysayers may point to the pension funds of such cities as San Diego and Minneapolis, which are currently struggling with underfunded pension plans. But these are pensions where individuals have no control over their contributions and where politicians, with the aid of accountants, can hide inadequate funding for a long period. The beauty of individual savings accounts is that each person decides how his money will be invested and, with the advent of the Internet, he can then monitor those investments at any time and easily make changes to react to changing investment news. Individual savings accounts are transparency in practice.

"The benefits of such reform extend beyond the individual retirement accounts of U.S. citizens (although that would be reason enough for reform)—they also accrue to the economy. As noted above, national savings will increase, as will participation in the labor force, both to the benefit of society. On the first point, more private assets means there will be more capital, which will have a positive impact on wages, which benefits the working people, especially the young. More capital also means that the economy will have more productive assets, which also contributes to more production.

"Regarding labor supply, any system that taxes people when they are young and gives it back when they are old will have a negative impact on labor supply. People will simply work less. Put another way: If people are in control of their own savings, and if their retirement is funded by savings rather than transfers, they will work more. And everyone is better off. These are the type of win-win situations that politicians and policy makers should be falling over themselves to accomplish.

"And those policy makers need to get beyond the idea of creating only voluntary savings accounts. Voluntary accounts are not the full answer. There is nothing wrong with making a reasonable level of savings mandatory. Remember that our current Social Security system is mandatory, but as it stands it is a mandatory tax that perpetuates a welfare system. It doesn't have to be this way. We should separate retirement savings from a system of welfare, and the most efficient way to do that is to turn our mandatory transfer system into a mandatory savings system.

"Some analysts have suggested that we can't move from a transfer system to a saving system because current retirees will be left in the lurch. Who will pay for them if workers' money is suddenly shifted to individual savings accounts? There will indeed be a period of time, likely no more than 10 years, when narrowly defined government debt relative to gross national income would increase before decreasing. But government debt is small relative to the present value of the Social Security promises that currently exist. Further, the sum of the value of government debt and the value of these promises will start declining immediately.

"Under a reformed system there will always be some individuals who, owing to disabilities or other reasons that prevent them from working, will not have sufficient savings in their old age. The solution is to include a means-tested supplement to ensure that those citizens receive a required payment—just like they receive today. Nobody gets left behind under this new system, and most will move ahead. U.S. citizens deserve more than a minimum payment, and the U.S. economy deserves more than to have its savings, capital and labor weighed down by an increasingly costly tax-and-transfer system.

"So how would such a reformed system work? Here's a proposal: Have three-quarters of employer and employee Social Security contributions (currently 12.4% of wages, salaries and proprietors' income up to $87,900) put into an individual savings account. This would be deferred income with taxes paid when people receive their retirement benefits. The other one-quarter of Social Security contributions would finance welfare and increase the labor supply, resulting in higher output and an increase in tax revenues.

"Reforming Social Security into a system of mandatory individual savings accounts is not as radical as it sounds. The world is moving in this direction, and here in the U.S. our citizens have been dealing with individual accounts for many years through their employers—and some of these are mandatory. As Ambrose Bierce's definition of radicalism suggests, someday we will look back and wonder what all the fuss was about."

Business Groups Prepare to Fight for Overhaul Of Social Security

Keith Koffler of *Congress Daily* reports that Bush's plans for Social Security will likely be bolstered by support form the business community. Contrary to reports that the business community supports privatization solely because it will help them financially, Koffler suggests that support is based more on philosophical agreement with personal ownership of the accounts and they economy-wide problems that would result from the collapse of the current program. Business groups were active in this year's elections and hope to continue their influence to produce sensible reform, Koffler adds. The full text of the article follows.

"President Bush's key allies in the business community are gearing up for the battle to overhaul Social Security with personal retirement accounts, preparing to provide critical support for what could be Bush's top legislative priority in 2005.

"Officials with the Alliance for Worker Retirement Security, the main business-backed coalition working for private accounts, will gather on Capitol Hill Thursday for their first meeting since the election.

"There, in separate sessions, about 20 lobbyists from groups that belong to the coalition will hear from Sen. Lindsey Graham, R-S.C., a proponent of establishing personal accounts within Social Security, and from Chuck Blahous, the White House point man on the issue.

"The alliance is located within the National Association of Manufacturers and includes leading trade groups such as the U.S. Chamber of Commerce, the Business Roundtable, and the National Federation of Independent Business, as well as companies such as Pfizer Inc., Charles Schwab & Co. and smaller companies.

“According to AWRS Executive Director Derrick Max, the business community may also revive the Coalition for the Modernization and Protection of American’s Social Security, which during the 2002 campaign spent millions touting business-backed Social Security overhaul. The group did everything from appearances at retirement homes to television advertising in major media markets, according to Max.

“Max said he huddled Tuesday with officials from the Business Roundtable, who would be key financial backers of any effort to revive CoMPASS. He did not provide details of the meeting.

“Since Election Day, Max has met with Democratic senators and other lawmakers and been in close contact with the White House and policy analysts at the Social Security Administration.

“‘We have a lot of interest in making sure we’re ahead of this and producing sensible reform,’ Max said.

“He indicated that members of his coalition and companies outside his group have been aggressively seeking him out since Election Day, primed to get started. He said the alliance will continue to set up meetings on Capitol Hill and is putting together briefing packets on the issue.

“Max said only a small proportion of his members were financial services companies. He indicated most of his membership was either philosophically supportive of personal accounts or believed such accounts were needed to prevent long term problems such as higher taxes to support Social Security or an economic deterioration of a fast-growing group of consumers: seniors.”

AARP Proposes Add-On Accounts

Last Thursday, AARP formally announced its opposition to President Bush’s plan to allow workers to divert a portion of their payroll taxes into personal retirement accounts as a means of reforming Social Security, according to a *New York Times* report by Robert Pear. Rather, the article continues, AARP supports the creation of add-on accounts, to which workers can voluntarily contribute. From the article:

“Marie F. Smith, president of the organization, said, ‘AARP adamantly opposes replacing any part of Social Security with individual accounts.’ But Ms. Smith added that the group supported incentives for people to establish personal retirement accounts in addition to Social Security.

“John C. Rother, the organization’s policy director, said, ‘We favor private accounts when they are in addition to Social Security, but not as a substitute.’”

In a 1999 Briefing Paper, Cato analyst Darcy Ann Olsen wrote that if Congress created add-on accounts, “Social Security’s unfunded liability would not change by a penny: the program would still face a $9.5 trillion liability [now estimated at over $11 trillion] because the new accounts would not bring revenue into the system or reduce benefit obligations to beneficiaries. In addition…those accounts will likely do little, if anything, to improve retirement security for the low-income workers whom they are designed to benefit."

Olsen shows that since most Americans already don't adequately prepare for retirement, creating an additional voluntary means of saving won't likely solve the problem, especially for low-income workers who don't have the extra income to set aside. The answer, Olsen concludes, is to allow workers to put the money they are already spending on payroll taxes to better use by investing it.

For more information on add-on accounts, see "Social Security Reform Proposals: USAs, Clawbacks, and Other Add-Ons," by Darcy Ann Olsen, Cato Briefing Paper no. 47, June 11, 1999.

The National Center for Policy Analysis also criticized the effectiveness of add-on accounts in a new "Fast Facts" bulletin released this week.

Democrats Should Embrace Privatization

The Yale Daily News featured a guest column this week by student Mike Slater, who writes that Democrats should embrace the reform of Social Security through private accounts rather than clinging desperately to the failing New Deal system. Slater discusses two particularly interesting facts in his commentary: first, he notes that the United States is woefully behind many other nations that have already adopted private accounts. Second, he points out that Franklin Roosevelt himself was hopeful that a time would come when private investment could perform the tasks assumed by government during the Depression. Slater's remarks follow.

"There's this inaccuracy in politics today that says liberals always favor reform and new ways of thinking and conservatives oppose progress and changes to the status quo. However, a simple comparison of each party's platforms makes it clear that Republicans have greater ideas for reform. Not only that, but their ideas concerning taxes, Medicare and school vouchers give more control to the individual. Republicans have, in the truest sense of the word, more 'liberal' values. If Democrats were truly progressive, they would work with President Bush on Social Security reform, the most urgent and promising reform on the table.

"The disastrous future of Social Security is a speeding train coming right at us, but many simply refuse to get out of the way. Even after the election, when everyone agreed that our political leaders needed to reach across the aisle for honest, non-partisan dialogue, House leader Nancy Pelosi said that, when it comes to Social Security reform, 'Democrats will stand our ground.' Will someone please tell her that Democrats are standing right on the tracks? Why are people stuck on this 70-year-old New Deal legislation? Social Security may have been a good idea then, but it is not a good idea today.

"In the current system, when a single male worker with average earnings retires, his real annual return will be 0.86 percent. For people who make over $80,000, their return is negative 0.72 percent. If, for the past 40 years, we had the capital-based system that President Bush is proposing, the average worker would have earned returns of 8.5 percent.

"Edward Prescott, co-winner of the 2004 Nobel Prize in Economics, believes that three-quarters of current Social Security contributions should be put into individual savings accounts, and the remaining one-quarter should finance welfare and 'increase the labor supply, resulting in higher output and an increase in tax revenues.' The non-partisan Commission to Strengthen Social Security, established by President Bush in December 2001, had a similar plan. It also decreed that 'modernization must not change Social Security benefits for retirees or near retirees—payroll taxes must not be increased—and government must not invest funds in the stock market.' But you wouldn't know this by listening to the Democratic leadership.

"The following are good, old-fashioned scare tactics. DNC Chairman Terry McAuliffe said that any reform of Social Security would turn it into 'Social Insecurity—that would expose our retirement savings to the whim of the volatile stock market.' Nancy Pelosi said Bush's plan 'would cut the benefits that provide financial security for millions of seniors and the disabled.' And Massachusetts Sen. John Kerry said Bush has 'The same bad, old idea of privatizing Social Security and cutting your benefits. That's not a plan—it's a rip-off.'

"Of course, all of these claims are—at the very least—misleading. Nowhere in Bush's plan is the taxpayer required to invest in the stock market. It was actually required in Clinton's attempt at reform for a certain percentage of your paycheck to go into the stock market. But in his plan, you couldn't even decide what stocks to invest in; rather, a newly formed federal board would determine where to put your money. The conflict of interest here is obvious, and the continual patronization of the American consumer is insulting. We are capable of choosing the investment strategy that fits us best. We don't need more federal bureaucracy telling us where to put our money.

"Under any type of reform, no current retirees would lose their promised savings. The change from a mandatory transfer system to a saving system won't happen overnight and suddenly leave retirees to fend for themselves. Transition costs to a new system will be around $500 billion over 10 years. While this may seem high, the cost of inaction is far higher. Five hundred billion is a lot of money, until you figure that Social Security will require a total of $27 trillion in additional funding over the next 75 years if nothing is done. In 2018, Social Security will spend more each year than it receives, and the problem will continue to get worse from there. The future numbers are staggering as we continue digging ourselves into a hole. Democrats need to look past the initial cost or else we are going to leave future generations a hole they can't climb out of.

"These ideas of reform aren't even that revolutionary. Chile, Sweden, Australia, Britain, China, Croatia, Poland and Peru have all reformed their state-run retirement programs. Why is America lagging behind?

"In a speech to Congress in 1934, Franklin Roosevelt said, 'I am greatly hoping for the repeated promises of private investment and private initiative to relieve the government in the immediate future of much of the burden it has assumed.' Seventy years later, the immediate future is now. We need to face reality. The speeding train is getting faster, and throwing money at it won't slow it down.

Heritage Scholars Debunk the Trust Fund Myth

Heritage Foundation scholars Brian Riedl and David C. John resolved lingering misconceptions about the Social Security "trust fund" in an commentary appearing this week in the *Kansas City Star*. Among other things, John and Riedl debunk the often-invoked myth that higher spending and greater deficits are the reason the trust fund is empty; they explain that by law, any surplus collected above what is needed to pay annual benefits must be invested in Treasury bonds, which effectively makes Social Security surpluses a part of the general revenue. Their commentary follows.

"President Bush wants Congress to make Social Security reform a top priority. This is because the program is in real trouble—worse trouble than most politicians and a surprising number of reporters are willing to admit.

"Although Social Security will fall into deficit into 2018, some assert that the program's trust fund will make up the shortfall, and therefore delay any tax increases or benefit cuts, until 2042. That is simply wrong. There is a trust fund, but it has no money in it and it never did. No money has ever been saved for future retirees.

"This means that the common myth that Congress and the president are raiding the trust fund is wrong also. As inventive as politicians are, even they can't steal money that was never there.

"Since 1940, the Social Security benefits received by retirees have been funded by the payroll taxes that workers pay. As long as there are enough workers to pay all the benefits owed to current retirees, the system is fine. Unfortunately, that's about to change.

"Today, there are just 3.3 taxpayers for each retiree. This is a sharp drop from 1950, when there were 16 taxpayers per retiree. In order to work properly, Social Security needs about three taxpayers per retiree. But with millions of baby boomers about to retire, and a much smaller number of new workers, by 2018 the program will have fewer than three workers per retiree and begin spending more each year than it takes in. That number will keep dropping until, around 2030, there will be two workers per retiree. At that point, married couples will have to support themselves, their children—and their very own retiree.

"Supposedly, that's where the 'trust fund' comes in. Although it has existed since the 1930s, it got a new purpose back in 1983, when the Greenspan Commission came up with an idea to pay for baby boomers' future retirements by raising the Social Security tax well above the amount currently needed to fund the program, and putting the extra money in the trust fund.

"Between 2018, when the program begins running a deficit, and 2042, the trust fund is expected to provide $5.7 trillion, about $100,000 per family, to pay benefits.

"One problem: the federal government wasn't allowed to actually save this money. Since 1939, federal law has required Social Security to 'invest' its extra money in Treasury bonds. In other words, the government lends the money to itself. Those funds are then mixed in with all other tax revenue and spent on programs such as education, foreign aid and defense.

"So in 2018, when the Social Security program tries to redeem these bonds, the Treasury (having already spent that money over the previous 35 years) won't be able to repay Social Security from any pre-existing store of cash. Taxpayers will be forced to pay extra taxes in order to fund 40 million retiring baby boomers.

"It's like a family that borrows money from its retirement fund each year to pay for vacations and expensive dinners. When they finally retire, their retirement fund consists of nothing more than paper IOUs.

"Some observers erroneously blame the budget deficits for the empty trust fund. Whether it is President Bush's tax cuts or John Kerry's health-care plan, critics regularly assert that any policy increasing the budget deficit would mean 'more money taken from the Social Security trust fund.'

"That claim is also wrong. The Social Security surplus is spent each year regardless of whether the budget is in surplus or deficit. When the federal budget is in deficit, the Social Security surplus funds current government programs. When the budget is in surplus, the Social Security surplus pays down the national debt. Either way, nothing is saved for future retirees.

"The demographics are already set. All of the taxpayers who will exist in 2018 have already been born. Social Security will need extra money starting that year.

"Given that, this country faces a choice. It can either condemn future generations to ever-higher taxes or sharply lower Social Security benefits, or it can change the system by allowing younger workers to place part of their taxes in safe, controlled investments. That will cost money also, but the money in those accounts would grow into pools of money that could pay some of the owner's Social Security benefits.

"However, before we can make that choice, we have to stop being distracted by thoughts of trust funds—especially ones that really have no money in them."

Salt Lake Tribune: *It's Time for a Detailed Social Security Plan*

A recent editorial in the *Salt Lake Tribune* states that the president needs to endorse a specific Social Security plan so that meaningful policy debate on the matter can begin. The key issue in the policy debate—the issue that will determine the fate of privatization—will be how the president proposes to deal with the transition costs in the face of ever-mounting deficits, the editorial continues. The complete text of the editorial follows.

"The smoke signals coming from the White House about Social Security reform are pretty hazy. The president says he wants Americans to be able to put a portion of their Social Security taxes aside in private accounts to invest for their own retirement. Beyond that, he hasn't offered many details.

"What's new is that President Bush is making the issue a top priority for his second term, which just about guarantees that a major political debate on retirement American style is at hand.

"This is not a new debate. Conservative think tanks, including the Heritage Foundation and Cato Institute, have been banging the drum for privatizing Social Security for about a decade. But the issue is complex, with winners and losers breaking along economic class lines.

"Nor is there any lack of possible reform plans. Numerous bills have been offered by Republicans and Democrats in Congress over the years. What has changed since many of these were first proposed in the 1990s is the economy, which has since endured a recession. The notion of investing their funds in the stock market may not look as attractive to many Americans now as it did in the '90s boom.

"The president can serve the public interest best by putting forward a detailed plan early next year so that it can be thoroughly analyzed and debated.

"The biggest question for the president is how he would pay for the transition from the current system, in which one generation pays for the next generation's retirement benefits, to one that would rely at least partially on private accounts. The difficulty of the transition is having enough tax revenues to pay the benefits of people who are already retired or who will retire in the next 10 to 20 years, while allowing younger taxpayers to divert a portion of their taxes into their own retirement accounts.

"When the federal government was running a budget surplus, it might have been possible to use those funds to finance the transition to private Social Security accounts. But the economic recession, the president's tax cuts, and the costs of war in Iraq have caused severe budget deficits, so it will be a greater challenge to finance that transition now.

"The major argument for privatized accounts is that the existing system of simply transferring wealth from one generation to another does not take advantage of compound interest or equity growth to produce a return on investment.

"Still, there are strategies that could shore up Social Security's financial strength in the out years of the baby boomers' retirement without redefining the system. Benefits could be means-tested, for example.

"So let the debate begin. The opening remarks are reserved for the president."

Upcoming Events

The Cato Institute will hold a conference on "Social Security: The Opportunity for *Real* Reform" on February 8–9, 2005. Speakers include Martin Feldstein, Thomas Saving, Kent Smetters, Robert Bixby, Jagadeesh Gokhale, Stephen Goss, Rep. Sam

Johnson, Rep. Jim Kolbe, and others. Mark your calendar. More information will become available soon.

Publications

The Cato Project on Social Security Choice is now offering an online version of its newest publication, *A Community Leader's Guide to Social Security Choice.* For more information, click here.

The Heritage Foundation released a paper describing its assessment of the optimal framework for Social Security reform. "How to Fix Social Security," by David C. John discusses in detail the basic structure reform should take. The paper can be seen here on the Heritage Foundation website.

The Center for Retirement Research has just added four new working papers to its website: "How Do Pensions Affect Actual and Expected Retirement Ages?," "Why Don't Americans Save?," "Sliding into Poverty? Cross-National Patterns of Income Source Change and Income Decay in Old Age," and "The Well-Being of Retirees: Evidence Using Subjective Data." To see these and other working papers from the CRR, click here.

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