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To: Those Interested in Social Security Reform

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Re.: Claims and Facts: Common Arguments Against Social Security Reform Featuring Voluntary Personal Retirement Accounts

In the debate over Social Security reform, the same arguments against voluntary personal retirement accounts are used again and again. While many objections to personal accounts sound convincing at first, analysis shows the most common claims to be flawed. The following memo examines some of the most frequently used arguments. More information on the Cato Institute's efforts toward Social Security reform can be found at www.socialsecurity.org.

<u>Claim</u>	<u>Fact</u>
Personal accounts mean large cuts in benefits for retirees.	<p><i>All existing personal account reform plans are certified by Social Security's actuaries to pay higher benefits than the current Social Security system will by law be capable of paying.</i></p> <p>Claims that personal accounts will cut benefits are scare tactics created by a selective and illogical use of definitions.</p> <p>Account opponents conjure up benefit cuts using two selective and biased assumptions:</p> <ul style="list-style-type: none">• First, they compare the benefits a reform plan <u>can</u> pay to those the current Social Security program promises but <u>cannot</u> pay. For Social Security to pay full promised benefits requires tax increases of over \$23 trillion (in today's dollars). They usually forget to mention these tax hikes.• Second, reform opponents do not count the benefits paid by personal accounts as "real," even if the account was invested solely in ultra-safe government bonds backed by the full faith and credit of the government. <p>When we compare the <u>total</u> monthly benefits paid under personal account plans to the benefits the current Social Security system can <u>actually</u> pay, it's an entirely different story.</p> <p>For instance, a 25-year-old low-wage woman retiring in 2042 is "promised" \$896 per month (in today's dollars) from the current Social Security program. However, because Social Security will be insolvent in 2042, <u>by law</u> the program can pay her only \$655 per month (with larger cuts in future years).</p> <p>Under the most "radical" plan from the President's Social Security Commission, this same woman could expect to receive \$611 in traditional benefits from the government plus \$375 from her account, for a total of \$986 per month. Her benefits would be \$331 per month more than Social Security will by law be able to pay, and \$90 more than Social Security even promises. Does this sound like a benefit cut to you?</p>

<p>Personal accounts would drain money from the Social Security trust fund.</p>	<p><i>The trust fund contains IOUs that can be repaid only by raising taxes or cutting other programs. Personal accounts replace those IOUs with real assets that can pay benefits without raising taxes.</i></p> <p>The Social Security trust fund contains \$1 trillion in government bonds that can help pay Social Security benefits in the future. But when these bonds are redeemed, the government must raise taxes or cut other spending to repay them. In truth, the trust fund cannot put off the need for additional revenue by a day or reduce the need by a dollar.</p> <p>Assets in personal accounts, by contrast, can pay benefits without raising taxes or cutting other spending. Which do you think is a better way to pay future Social Security benefits?</p> <p>Moreover, Social Security's actuaries say "if the personal accounts are considered as part of 'Social Security', it is reasonable to combine the amounts of Trust Fund assets and personal accounts for a representation of total system assets."</p> <p>Consider what that would mean. If the current Social Security program were to continue to pay full promised benefits, by 2076 it will have run up a <u>debt</u> worth \$3.23 trillion.¹ By contrast, even under the President's Commission's Plan 1, which makes no structural changes to Social Security's revenue or benefit formulas other than to incorporate optional personal retirement accounts, Social Security's deficit is reduced to \$2.75 trillion (and all workers receive higher benefits than under the current system). Under the Commission's Plan 2, Social Security would have net <u>assets</u> worth \$1.67 trillion, and under Plan 3, \$1.79 trillion.</p> <p>Arguments that personal account plans "de-fund" Social Security are clearly rebutted by these figures.</p>
<p>High administrative costs would send all the account profits to Wall Street.</p>	<p><i>Personal account plans would have administrative costs just one-fifth those of the average mutual fund and significantly cheaper than the average IRA or 401(k) account. If IRAs and 401(k)s are affordable, personal accounts will be even more so.</i></p> <p>The average mutual fund has annual administrative costs of 1.5 percent of assets managed. Social Security's independent actuaries estimate that personal retirement accounts could be administered for a cost of 0.3 percent of assets managed. That means that if your account investments returned 5.0 percent, you would keep 4.7 percent.</p> <p>Administrative costs for personal accounts involve the collection, investment and distribution of contributions. These costs are important because they come straight off the return an investment account earns.</p> <p>But "it is not a necessary condition that administrative costs eat up returns," says William Shipman of CarriageOaks Partners and co-chair of the Cato Institute's Social Security project. "It depends on how you design the system." Shipman designed a personal account system with State Street Global Advisors with costs of just 0.2-0.3 percent assets managed. The State Street plan counted everything from investment management to the postage cost of mailing account statements.</p>

¹ All figures cited in this paragraph are present values, i.e., the amount we would have to invest today (at the government bond interest rate) which compounded over time would equal the number cited for the year 2076.

	<p>Other studies and international experience found similar low costs. For instance, <i>Pensions International</i> magazine reports that the annual management fee for Chile's system of personal accounts is just \$12.68 per worker, comparable to the U.S. Social Security system. The Congressional Budget Office notes that Chilean account "costs are now about 1 percent of accumulated pension assets, which is similar to the average cost of managed mutual funds in the United States." The Australian system of personal accounts, which began in 1992 and uses almost totally private administration, had by 1997 lowered administration costs to just eight-tenths of one percent, with further reductions expected to follow.</p> <p>The United States has the most advanced capital markets in the world. There is no reason to believe a workable and affordable system of personal accounts cannot be established.</p>
<p>Workers who retired in a down market would be left with nothing. Personal accounts would turn Social Security into a system of "winners and losers."</p>	<p><i>Stock prices go up and down, but there is no 20-year period in all of American history when stocks have lost money. And over the long term stocks have actually been less risky than "safe" government bonds. Even a worker retiring in today's "bear market" would receive higher benefits with a personal account than if he had stayed in the current system.</i></p> <p>Wharton School finance professor Jeremy Siegel finds that stocks have been remarkably safe investments over the long term. It is not simply that they have produced higher returns – they have, averaging 7 percent after inflation versus 3.5 percent for government bonds – but that long-term stock returns have actually varied less than those of bonds.</p> <p>Moreover, almost no workers invest solely in stocks over their lifetimes. Most investors are far more conservative, diversifying into less volatile corporate and government bonds. An average 65-year-old worker has only about 35 percent of his retirement savings in the stock market.</p> <p>How would this worker have fared in the past year? Believe it or not, he would have done just fine. The 25 percent drop in the S&P 500 would have been more than countered by the 13 percent rise in the Lehman Brothers U.S. Aggregate Bond Index. In fact, he would have <i>made</i> money last year.</p> <p>Finally, Social Security itself is anything but risk-free. The 1960 Supreme Court ruling in <i>Fleming v. Nestor</i> declared that Congress can change the terms of the deal whenever it wants, raising your taxes or cutting your benefits at any time, by any amount, for any reason. And it has – the 1983 "reforms" raised taxes, increased the retirement age and imposed income taxes on retirees' benefits. Given that the current system faces over \$23 trillion in payroll tax deficits between today and 2076, it is a certainty that some or all of these steps would be repeated. That's not what workers and retirees bargained for.</p> <p>Under a system of personal accounts workers would truly own their retirement assets and the government could no more take away their Social Security benefits than it could take the money out of their IRA or 401(k) account.</p>
<p>The benefit cuts in personal account plans would force workers to delay their retirement.</p>	<p><i>A 25-year-old low-wage woman would have to work past age 70 under the current program to receive the same benefits she could receive at age 65 under the President's Commission's Plan 2.</i></p> <p>Critics accuse reform plans of increasing the retirement age. In fact, none of the plans from the President's Commission would alter Social Security's retirement age by even a day. Workers could still retire beginning at age 62, as under current law.</p> <p>Moreover, since personal accounts would pay higher benefits than the current program will be able to pay, workers could retire earlier than under current law.</p>

Personal accounts would force workers into the stock market, risking their retirement savings as Enron employees did.

All personal account plans from the President's Commission are voluntary: no worker is forced to hold an account and no worker with an account is forced to invest even a penny in the stock market. Accounts would be modeled after Federal workers' retirement plan and could hold only safe, diversified stock and bond mutual funds.

The beauty of personal accounts is that they are voluntary. Workers who want an account can take advantage of private investment, those who wish to remain in the current program can do so. All workers aged 55 and over would remain in the current system and receive every penny they have been promised, including annual Cost of Living Adjustments (COLAs).

The President's Commission modeled its personal accounts after the federal Thrift Savings Plan, which requires that workers invest only in approved, low-cost, diversified stock and bond mutual funds. Millions of federal workers are happy with the TSP. Shouldn't ordinary Americans have a similar option?

Moreover, a recent National Public Radio poll showed that most Americans think the Enron scandal is a reason for personal accounts, not against them. Individuals were asked whether:

- "Now is not the time to turn Social Security over to the stock market. We need changes to improve Social Security, but not ones that reduce the guaranteed monthly benefits for future retirees. Or...
- "What happened at Enron proves people need more choice and to be in control of their own retirement options, including the right to invest a portion of their Social Security taxes into government approved and diversified mutual funds?"

By 55 to 39 percent, respondents said the Enron scandal *strengthened* the case for personal accounts.

A focus on scandal misreads the public's desire for the control, ownership and accountability that personal accounts can provide.