Social Security privatization
CATO INSTITUTE

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

WEEK OF JANUARY 3, 2000

McCain To Propose Personal Accounts

Reports out of Iowa are that Republican presidential contender Sen. John McCain (R-AZ) will next week propose a reform plan allowing workers to divert 20 percent of their payroll taxes (2.5 percentage points) to personal accounts. While details are still sketchy, McCain also reportedly plans to go beyond the "lock-box" – which devotes surplus payroll taxes to debt reduction – by dedicating 60 percent of the projected on-budget (non-Social Security) surpluses to Social Security.

Campaign Trail Update

Social Security continues to be an active issue on the presidential campaign trail. In addition to John McCain's reported decision to announce a personal retirement accounts proposal, Republican contender Steve Forbes has been running television ads and making appearances actively promoting his privatization plan in New Hampshire. Meanwhile, Donald Trump declares in his new book, *The America We Deserve*, that he would let workers invest at least a portion of their Social Security payroll taxes in the market through personal accounts.

Clinton Revives USA Accounts

President Clinton is reportedly ready to use his State of the Union address to revive his proposal for so-called "USA Accounts." These subsidized private investment accounts were originally put forward in tandem with Clinton's "Save Social Security First" plan in the 1999 State of the Union. USA Accounts were dropped over the past year. But in this year's address, to be delivered January 27th, Clinton will once again propose to subsidize savings by low-income individuals through personal retirement accounts.

The plan, costing around $250 billion over ten years, would provide low-income workers a subsidy of up to $300 per year, plus matching a portion of their own savings. The subsidy and match would be phased out for higher-income workers.

Clinton's USA Accounts proposal is important in one respect: it recognizes that personal retirement accounts are practical even for the lowest earning workers. But don't confuse USA Accounts with Social Security reform: workers must still pay 12.4 percent of their wages to a program that may not pay them back.

And there is good reason to believe that USA Accounts won't benefit low-income workers even as supplemental savings. Darcy Olsen, in her Cato Briefing Paper *"Social Security Reform Proposals: USAs, Clawbacks, and Other Add-Ons,"* analyzes data from 401k and other supplemented pension programs, finding that participation rates among low-income workers are poor. Social Security reform is still the best route to a safe retirement for America's low-income workers.

Replacement Rate Reductions

An important measure of any pension program's adequacy is its ability to replace earnings lost due to retirement. Experts estimate that a retiree needs 60 to 80 percent of his pre-retirement income to maintain his lifestyle. By this standard, a new study from the Congressional Research Service, "Social Security Reform: Assessing Changes to Future Retirement Benefits," shows Social Security going from bad to worse.

According to the study, in 1995 Social Security replaced 43 percent of the average worker's earnings. In other words, if that worker depended primarily on Social Security – as up to one quarter of retirees do – his income in retirement would be less than half what he received while working. But that's not the worst of it. As Social Security's financing condition worsens, it will replace less and less of workers' pre-retirement incomes. In 2010 the replacement rate will fall to less than 40 percent; by 2030 it will be only 36 percent.

Retirement should not cut a worker's income by one-half to two-thirds. And it doesn't have to. Under a fully implemented private investment plan, a worker could easily have a higher income in retirement than while working, thanks to the higher rates of return available in private markets.

Social Security and Divorce

In a new issue brief, the Urban Institute's Eugene Steuerle and Christopher Spiro outline the "rocky marriage" between divorce and Social Security. When Social Security was designed in the 1930s, divorce was rare. Consequently, the system is ill suited to today's environment, in which ten percent of the adult population is divorced.

Currently, a divorcee receives Social Security benefits only if he or she was married for ten years or more. Steuerle and Spiro point out a number of paradoxical results:

- A serial spouse can leave the public holding the bill for multiple ex-spouses, all of whom could receive full benefits.
- The death of a former spouse can provide a payoff by replacing spousal benefits with higher survivors benefits.
- Ex-spouses who never worked sometimes receive more than single parents who contributed to Social Security.

The Urban Institute's research on Social Security reform is available here.

Since a privatized Social Security system accumulates real financial assets in personal accounts, divorcing spouses can divide those assets equally. This is particularly important to women, who often suffer financially following divorce. A divorced spouse carries assets with her, rather than relying on the former spouse's eligibility, giving her greater security and independence than under the current system.
For more information on the benefits of privatization to women, see Darcy Olsen's **Greater Financial Security for Women with Personal Retirement Accounts**.

A Compound Interest Quiz

Here's a simple quiz to show the power of compound interest:

The Dow Jones index ended the 20th Century at around 11,000. If it continues to grow at eight percent annually – a lower rate than over the past 100 years – what will the Dow Jones's value be at the end of the 21st Century?

The answer? 24,197,373. Yes, that's over 24 million.

Now you know why Einstein called compound interest the most powerful force in the universe. And why Social Security reform should harness that power by investing payroll taxes in the market.

Social Security Survives Y2K…But What About 2014?

The Social Security system survived the Year 2000 computer problem without a hitch, reports the Social Security Administration. "When I said a few weeks ago that our customers could rely on us in January, just as they've relied on us in the past, I meant it," stated Commissioner Kenneth Apfel.

But even if Social Security made it through Y2K, 2014 is the year workers should really worry about. 2014 is when benefit payments exceed payroll tax revenues; to cover the gap, taxes must increase or other government spending be reduced.

In a January 3 *Washington Post* article, "Issues and Trends for 2000 and Beyond," Hudson Institute senior fellow Michael Fumento commented on the implications of 21st Century health care: "The natural full human lifespan of about 120 years will be reached by more and more people; then that lifespan itself will be extended. The effects on society of all these chipper geezers will be profound and can only be guessed at, though one thing is for certain: The current Social Security system is already dead. It just doesn't know it yet."

Publications of Interest

The Congressional Research Service published a new study (mentioned above), *Social Security Reform: Assessing Change to Future Retirement Benefits*. While the

CRS does not distribute studies directly to the public, you can obtain a copy through your Member of Congress.

The Heritage Foundation recently published a new book, *What Social Security Will Pay: Rates of Return by Congressional District,* by Gareth G. Davis and Philippe J. Lacoude. It is available for download in Adobe Acrobat format or can be purchased for $12.95.

In a humorous piece, *Reason Magazine* reporter Michael Lynch takes a road trip to West Virginia in search of the Social Security Trust Fund. What he found was a laser printer, a safe and some very evasive answers. Click here to read.

Upcoming Events

On March 9-10 in New York City, the Cato Institute and *The Economist* will co-sponsor *Solving The Global Public Pensions Crisis II: The Privatization Revolution*, featuring distinguished international and American speakers analyzing the success of privatization abroad and the challenge of reform in the U.S. For information, call (202) 218-4633.

Michael Tanner of the Cato Institute will debate Social Security reform January 15 at College Convention 2000, a non-partisan meeting of college age voters taking place in Manchester, New Hampshire. For information on the conference, call (603) 883-2225.

On January 25-26, CSIS will hold a Conference on Global Aging, examining the economic, social and strategic impact of aging on industrialized nations. For more information, contact Michael Crowley at (202) 775-3172.

To subscribe or unsubscribe, or if you have any Social Security related stories or events you think should be included in *Social Security This Week*, contact Andrew Biggs at (202) 789-5205 or abiggs@Cato.org. *Social Security This Week* is also available at Cato's Social Security website, www.socialsecurity.org.