

Social Security Choice

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

WEEK OF FEBRUARY 4, 2005

Bush Fills in the Details on Personal Retirement Accounts

In his highly anticipated State of the Union address this week, President Bush pledged his support for personal retirement accounts. For the first time since entering the Social Security debate, Bush gave listeners a brief outline of the plan he intends to promote and sell to Congress. The president's plan calls for the phased-in creation of personal retirement accounts that are 4 percent of a worker's wages, roughly one-third of the payroll tax. Several key features of the plan (gathered from White House press briefings, the address itself, and White House fact sheets) are listed below.

- There will be no changes in the current system for people who were born before 1950—those who are 55 and older now. If you were born in 1949 or before, you would not be impacted by any of the changes envisioned by the president for Social Security.
- The system will initially operate much like the Thrift Savings Plan for government employees. Workers would have a choice from a small number of broadly diversified funds with a life cycle fund as the default. Funds would be managed by the private sector on a contractual basis and administered by the federal government. Early estimates by the Social Security Administration indicate that administrative fees could be kept as low as .3% annually of assets under management.
- Yearly contribution limits would be raised over time, eventually permitting all workers to set aside 4 percentage points of their payroll taxes in their accounts. Annual contributions to personal retirement accounts initially would be capped at \$1,000 per year in 2009. The cap would rise gradually over time, growing \$100 per year, plus growth in average wages. By 2014 about half of American workers would be able to privately invest 4 percent of their wages.
- To ease the burden of transition costs, the accounts would be phased in according to the age of the work force. The first year of the program (2009), those born between 1950 and 1965 could enter the system. The second year, those born before 1978 could enter. And in the third year of implementation, all eligible workers would be able to participate in personal accounts if they chose.

- Participants would not be permitted, under the system, to have pre-retirement access to their personal accounts. The accounts will be held and protected to fund benefits when they hit retirement age. They would not be permitted to make loans to themselves through the accounts, nor would they be permitted to borrow against them.
- Accounts would belong to workers and be fully inheritable.

Though the president has taken a bold step in the right direction with this proposal, four percent accounts would not have many of the benefits of larger accounts, such as those supported by the Cato Institute. For a look at the benefits of larger accounts, see Michael Tanner's "[The 6.2% Solution: A Plan for Reforming Social Security](#)," Cato Project on Social Security Choice Paper No. 32. Additionally, the president will have to look at proposals for maintaining long-term solvency, including the possibility of indexing benefits to prices, rather than wages.

Inaccurate Characterization of PRAs in the Washington Post

The *Washington Post* ran an article Thursday morning by Jonathan Weisman titled "[Participants Would Lose Some Profits From Accounts](#)." In it, Weisman asserted that the president's plan for personal accounts involved "claw backs" that would eat away at profits. From the original article:

Under the White House Social Security plan, workers who opt to divert some of their payroll taxes into individual accounts would ultimately get to keep only the investment returns that exceed the rate of return that the money would have accrued in the traditional system....

Under the proposal, workers could invest as much as 4 percent of their wages subject to Social Security taxation in a limited assortment of stock, bond and mixed-investment funds. But the government would keep and administer that money. Upon retirement, workers would then be given any money that exceeded inflation-adjusted gains over 3 percent.

In response to the article, which has since been amended on the *Post's* website, the White House issued the following fact sheet:

President Bush's plan allows you to make a decision to put your money in a different kind of prudent investment, with the potential for receiving higher pay-outs.

- For example, a worker who decides against taking a personal account might, in the future, get \$15,000 annually in benefits from the traditional system, reformed to be permanently sustainable.
- Another young worker could choose to invest in a personal retirement account. In exchange for the right to get the account, he gives up benefits from the traditional system. For example, he might give up one-third of those future government benefits, and be entitled to receive \$10,000 annually from the traditional system.

- A personal retirement account would belong entirely to the worker. If the account earns a 3% real rate of return—the worker would be right back where he started—at \$15,000 of combined benefits per year.
- A worker could earn a higher return through his personal account investments. The Social Security Actuary assumes he will invest in a conservative mix of stocks, corporate bonds, and government securities that would result in a 4.6% real rate of return. In this case, the account would be large enough to provide about \$7,000 per year of benefits, so he would have a combined future benefit of \$17,000. His combined benefit would be \$2,000 per year higher than had he not chosen the account.
- A worker's traditional benefit would be affected by the amount of investment in a personal account because some of his payroll taxes are flowing into the account, rather than into the traditional Social Security system. His government benefit would not, however, be affected by the investment performance of the personal account, as was suggested in today's *Washington Post*.
- Note that if he puts all of his account into safe government securities, he can expect an average 3% real rate of return (the break-even rate). In addition, the worker will own all the funds in the account. Even if the worker were only to break even financially, he would be better off because of his ownership rights:
 - If he were to die before retirement age, he would have an asset to pass on to his loved ones.
 - If he were to divorce, his account would be marital property.
 - And if future policymakers were to change government-provided benefits, his account balance would be immune from those changes.

The amended version of the *Post* article corrects its errors, noting that workers with an account would only lose “a proportionate share of their guaranteed payment from Social Security plus interest. They should be able to recoup those lost benefits through their private accounts, as long as their investments realize a return greater than the 3 percent that the money would have made if it had stayed in the traditional plan.”

Attacks on PRAs Intensify before the State of the Union Address

Though the White House issued statements early in the week indicating that the president would offer new details on his Social Security reform proposal in Wednesday's State of the Union address, Senate and House Minority Leaders Harry Reid and Nancy Pelosi couldn't be bothered to wait for the plan in order to begin their attacks on it. The two issued a joint “pre-buttal” to Bush's speech on Monday, focusing largely on Social Security and the situation in Iraq. Pelosi attacked the idea of personal retirement accounts, saying that “President Bush sees undermining Social Security as the cornerstone of his ownership society. Democrats will not allow this administration to

turn this proud, entrepreneurial achievement of the New Deal into a raw deal for millions of Americans.”

Joining in the pre-emptive strike against the president’s plan was MoveOn.org, which launched an ad campaign this week targeting congressmen whose constituencies are divided on the subject of personal retirement accounts. MoveOn.org also placed a full-page ad in the *New York Times*. The ad claims that “Social Security can meet 100% of its obligations for the next 37 years with no changes to the current system, according to the Social Security Administration itself.” It fails to point out, however, that beginning in 2018, the system will begin paying more in benefits than it takes in through payroll taxes, causing an enormous strain on general revenues to make up the shortfall.

Bob Kerrey on Social Security Reform

Writing in the *Wall Street Journal* this week, Bob Kerrey, the former Democratic Senator from Nebraska, sharply criticized the current Democratic leadership for their unwillingness to contribute meaningfully to the reform process. He notes that President Bush’s plans for Social Security reform shouldn’t be looked at as an end to Social Security, but as an opportunity to fix inadequacies of the system while ensuring the goals of keeping the elderly out of poverty, generating wealth for lower income workers, and improving the quality of life for retirees. His comments follow.

“The late Pat Moynihan used to joke when I asked him why liberals were so reluctant to consider changing Social Security so that it guaranteed wealth as well as income: ‘It’s because they worry that wealth will turn Democrats into Republicans.’ Leaving aside that possible correlation, it will be a shame if liberal voices, values and ideas are not brought into the debate initiated by President Bush’s Social Security reform proposal. To make certain the reforms are done correctly liberal thinking is urgently needed.

“There is no doubt that Social Security and Medicare are two of liberalism’s most enduring and popular triumphs. And there is no doubt that a vocal and influential minority remains true to its strong conservative belief that the Social Security Act of 1935 and the 1965 amendments to this act, which created Medicare and Medicaid, represent socialistic and dangerous interferences with the marketplace. However, liberals are wrong to fear that President Bush’s proposal represents a threat to Social Security.

“I sincerely hope they do not merely defend their proudest achievement. I hope they see that President Bush is giving them an opportunity to finally do something about the rich getting richer and the poor getting poorer.

“First of all, fears that Social Security will be destroyed are exaggerated. Across all generations and within both major parties, Social Security and Medicare are seen as a vital part of American life. They represent a powerful intergenerational contract between younger Americans in the work force who agree to be taxed on behalf of older, eligible Americans. What makes the contract work is that the expectation of those in the work force is that when they pass the age of eligibility, successive generations of workers

will not object to the taxes that must be imposed on them to cover the costs of their income and health benefits.

“Secondly, President Bush’s fears of a bankrupt Social Security and his rhetoric of the program being in financial crisis are also exaggerated. Relatively small changes in taxes and/or benefits would restore the promise to all living beneficiaries—those eligible today and those eligible in the future. Unlike the situation that existed in 1983, when Congress and the president acted to avoid a financial crisis, today’s financial problems are relatively small.

“On the other hand, there are two problems with Social Security that are serious enough to be called a crisis. The first is that in eight years the income from a 12.4% payroll tax will be insufficient to pay the old age, survivor and disability benefits owed at that time. From that point on, Social Security will begin to redeem some of the hundreds of billions of dollars of Treasury bonds it has ‘accumulated in the trust fund’ in order to issue monthly checks to beneficiaries.

“Though these bonds are far from ‘worthless,’ as some critics allege, the picture of them ‘accumulating in a trust fund’ is not accurate either. That is because, in order to convert these bonds into cash, the U.S. Treasury will use the cash from individual and corporate income taxes. While some income taxes are currently used to pay Social Security benefits, the dollar amounts do not pose a serious budgetary challenge. In eight years that will change. Coupled with the cost of Medicare and Medicaid, the annual benefit demands of Social Security will put real pressure on Congress to cut spending on defense and nondefense appropriations.

“It is at this point in time that the demographic and monetary demands of the baby boom generation will become painfully apparent. The disinvestment in public infrastructure caused by the growth in Medicare and Medicaid will become even worse than it is today. And the nature of this crisis will be considerably more daunting than that faced squarely by Congress and the president in 1983. Liberals, who have silently watched the share of state and federal spending apportioned to the elderly grow at the expense of education, training, child care and research, will be appalled to discover how much their silence has cost them.

“The second crisis is the one for which liberals are even more urgently needed. This crisis is the shockingly low rates of savings and pitifully inadequate amount of preparation being made by American households for their old age. If liberals were to join this debate and insist upon provisions that would lead to dramatic reductions of the numbers of poor elderly, the outcome could be a dramatically enhanced quality of life for all, reduced dependency upon welfare in old age, and downward pressure on the social costs of growing old.

“If liberals joined this debate they would insist that the guaranteed transfer payment of Social Security remain intact. With the evidence that trade, technology and immigration are putting downward pressure on unskilled wages, they might even be able to succeed in changing the current benefit formula so that more than 50% of the first \$900 of income was replaced. Perhaps they could even convince their Republican colleagues to eliminate penalties that affect stay-at-home women.

“Liberals would fight to make certain that contributions to private accounts were progressive in order to benefit lower-wage workers. They might even argue that accounts be opened at birth, thus giving Americans the longest possible time to accumulate wealth. No doubt they would insist that investment options be carefully regulated to keep administrative costs and risks as low as possible. And since liberals oftentimes understand the good that markets can do even more than some of their conservative colleagues, they could see the wisdom of changing the tax code so that no income taxes were levied on income that went into these savings accounts. All of these would practically guarantee a muscular market response that would give future Americans larger amounts of insured non-employment income to add to the \$800 per month on average they receive from Social Security.

“None of this will happen if liberals merely shout ‘hell no, we won’t go.’ The best they can hope for with that strategy is to prevent reform from happening. They should feel no pride of accomplishment if that is the result.”

One Million Students for Social Security Choice

This week a coalition of college students and community activists announced the formation of One Million College Students For Social Security Choice (OneMillionCollegeStudents.com) to address the impending Social Security crisis.

The immediate goal of One Million College Students For Social Security Choice is to get one million students to sign an online petition, which shows their support for Social Security reform. The website also educates college-aged Americans on the issues behind Social Security reform and how the decisions made about the program today will affect them in the long term.

Events

If you haven’t yet registered for next week’s conference on Social Security reform at the Cato Institute, now is the time. Confirmed speakers during the two-day conference include Nobel Laureate Edward Prescott, CBO Director Douglas Holtz-Eakin, Rep. Sam Johnson (R-TX), and Alan Hubbard, Chairman of the National Economic Council. For more information or to register, click [here](#).

Publications

The Social Security Administration has released the latest issue of its newsletter, “[International Update](#).” The publication for January looks at the most recent international developments concerning pension reform. This month’s issue discusses movements toward reform in Austria, Malta, the United Kingdom, Chile, and Kazakhstan.

Boston College released a new paper in its “Just the Facts” series this week entitled “[What Does Price Indexing Mean for Social Security](#),” by Alicia Munnell and Mauricio Soto. The paper is an excellent look at what price indexing is and what it will

do to Social Security's guaranteed benefits. The authors conclusions, however, that price indexing could lead to increased welfare needs for retirees, doesn't take into account the possibility of private accounts, which could more than make up for the benefit reductions related to price indexing.

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