



Social Security Choice

SOCIAL SECURITY THIS WEEK

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Cato's Social Security Solution

After more than 25 years at the forefront of the push to reform Social Security, the Cato Institute today, for the first time, unveils a detailed blueprint for returning solvency to the government's ailing retirement system. Michael Tanner, director of the Cato Project on Social Security Choice and a leader of the drive to reform Social Security, wrote the Cato plan, which allows younger workers to invest half of their FICA payroll taxes in individual accounts. The plan also takes into account older workers who have already invested heavily in the current Social Security system, quashing one of the most common arguments against individual accounts.

Tanner's plan, detailed in "[The 6.2 Percent Solution: A Plan for Reforming Social Security](#)," gives all workers born on or after Jan. 1, 1950, the option of remaining in the Social Security system or having half of their FICA tax—or 6.2 percent of their salary—deposited in individual accounts. The other half of the payroll tax, the portion paid by employers, will cover transition costs and underwrite disability and survivors' benefits. Workers already enrolled in the current system who opt for the new plan would receive a "recognition bond," redeemable upon retirement and fully tradeable, based on the amount they have paid into the old plan.

"The American people can handle an open and honest debate about Social Security reform," Tanner says. "Individual accounts will create a better, fairer, and more secure retirement system."

Benefits of the Cato approach include:

- **Ownership:** Participants own their fully-inheritable investments.
- **Solvency:** The plan returns Social Security to long-term solvency at a lower cost than propping up the existing program.
- **Higher Benefits:** Workers who opt out of the existing system will receive substantially higher benefits than they would under the current program.
- **Fairness:** The proposed program offers greater benefits to women, minorities and low-income workers.

- **Accountability:** Retired workers and those near retirement will not see their benefits reduced.

In short, the Cato plan puts individuals, not the government, first. It protects younger workers and future generations. It puts citizens in charge of their retirements. It allows workers to keep more of their own assets. As Tanner writes: “It would be a profound and significant increase in individual liberty.”

White House: Social Security Reform Key to Long-term Debt Reduction

Allowing younger workers to privately invest a portion of their Social Security taxes through individual accounts would increase budget deficits in the short-term, but would substantially reduce government debt in the long run, according to a new report by the White House Council of Economic Advisors.

The CEA warned against allowing concern over current budget deficits to derail proposals for reforming the program:

The presence of a deficit in the non-Social Security part of the budget may make it more difficult to persuade lawmakers to reform Social Security, if the transition costs of the reform cause the deficit to eclipse a previous record. However, avoiding Social Security reform will not keep deficits in check. If nothing is done to reform Social Security, under current projections, the growth of Social Security, Medicare, Medicaid, and the interest on the borrowing required to finance their growth will lead to unified budget deficits that surpass previous records as a share of GDP.

The CEA went on to note that “the economic rationale for undertaking [Social Security] reform in an era of budget deficits is as compelling as it was in an era of budget surpluses.” Indeed, it may be more so:

Policy makers concerned about the unified deficit will have to decide how they will restrain Federal spending over the upcoming decades—they will have to confront this question even if nothing is done to reform Social Security. The benefit of reforming Social Security is that it alleviates, to some extent, the financial burden that unreformed entitlement programs will place on future generations. ...

To do nothing at this point to restrain the growth of entitlement programs would bequeath to future generations an increasing tax on their income to support Social Security. The only way to avoid such an outcome without reducing the living standards of future retirees is to save more today. ... The combination of reducing the projected cost of taxpayer-financed benefits and shifting the revenues into personal retirement accounts provides the best mechanism for achieving that result.

The CEA report made several other important points as well:

- “Allocating Social Security surpluses to special issue Treasury bonds in the Trust Fund provides no guarantee that future Social Security benefits are prefunded.”

- Moreover, “[Focusing] on the date of Trust Fund exhaustion is inadequate as a measure of Social Security’s financial health because this date, by itself, gives no indication of how dire the fiscal situation becomes *after* the Trust Fund hits zero.”
- Direct government investment of Trust Fund assets in private capital markets would be a dangerous mistake. “...in order to cover the annual deficit in 2080 through prefunding, a portfolio the size of at least two-thirds and possibly more than 100 percent of all mutual funds would have to be accumulated. A portfolio of this size is simply too large to be administered centrally without political interference and without disruption to capital markets.”
- Because individual Social Security accounts are controlled by individual workers and are separate from government, “the accumulation of assets in those accounts would not provide any impetus for higher government spending in the non-Social Security part of the budget.”
- Individual accounts would provide higher retirement benefits than Social Security could otherwise afford to pay. “Personal retirement accounts would provide a way for individual workers to accumulate assets to offset the reduction in their total retirement income that otherwise would occur...”

The CEA report concludes that:

“...a Social Security reform plan should have two components. First, it should restrain the growth of future pay-as-you-go benefits for those not currently in or near retirement to bring the cost rate of the program in line with the income rate in the long term. Second, it should establish personal retirement accounts for each worker.”

The Cato Institute has just released a Social Security reform plan that includes both of those provisions. For more information, see highlights of [Cato's Social Security Plan](#).

Latest Polling: Little Confidence in Social Security

Americans continue to have serious doubts about whether Social Security will be there for them, according to a new poll by Opinion Research Corporation. The poll of 829 adults, taken in November 2003, found that 60 percent of Americans were either “not too confident” or “not at all confident” that Social Security would still exist when they were ready to retire. Just 14 percent were “very confident” in Social Security’s future. Not surprisingly, young people were the most skeptical, with 73 percent expressing little confidence that Social Security would be there for them. The poll had a margin of error of +/- 3 percent.

Public opinion polling has consistently shown that the public is worried about the future of Social Security and is seeking alternatives. In particular, the public continues to strongly support allowing younger workers to privately invest a portion of their Social Security taxes through individual accounts. Last week, *Social Security This Week* reported on a Fox News/Public Opinion Dynamics poll showing that two-thirds of voters supported individual accounts.

In a 2003 study for the Cato Institute, John Zogby analyzed years of public opinion polling about Social Security and found that a substantial majority of the American public supports proposals that would allow them to invest a portion of their Social Security taxes through individual accounts. That support has been consistent over time and is seen in a broad range of public opinion surveys. The handful of public opinion surveys showing less support for individual accounts are based largely on biased questions.

Support for individual accounts is based on the belief that Americans should have control over their own money and retirement—rather than higher rates-of-return or higher benefits. As a result, support for individual accounts is less subject to erosion through outside events, such as fluctuations in the stock market.

Private Account Movement Reaches China

[James A. Dorn](#), China specialist at the Cato Institute, highlights China's movement towards personal retirement accounts in his *Wall Street Journal* commentary, "A Fix for China's Pensions." Much like the current situation in the US, China's pension system is in need of reform due to the unsustainable nature of their pay-as-you-go program. Consequently, China's political leaders are beginning to consider private accounts as a solution for the system's unsustainable course. Dorn asserts that private accounts will not only fix the system's financial problems but will empower workers by expanding ownership. Excerpts from his commentary follow:

"Prior to leaving office last year, Chinese Premier Zhu Rongji argued that pension reform is 'the lifeline of our workers.' He thus recommended that retirement funds be professionally managed and workers be given a wider range of investment options. He was right. Moving from a pay-as-you-go system to a fully funded system, in which workers have property rights in their retirement accounts, is what China needs. It is also surely consistent with the socialist goal of empowering workers—a point [José Pinera](#), the architect of Chile's successful privatization program, made when he visited China in 1997.

"Today China has a highly fragmented social security system confined primarily to workers in urban state-owned enterprises (SOEs). The high payroll tax rates and precarious nature of the system have led to noncompliance and evasion, and workers in the growing nonstate sector have little incentive to join.

"China's aging population will sharply increase the number of retirees who have to be supported by each worker over the next few decades. That demographic problem combined with the inability of SOEs to cover even the pensions of current retirees makes reform of the system a top priority.

"Some steps have already been taken. In 2001, China's ruling State Council sanctioned an experiment in the northeastern province of Liaoning, intended to increase the use of 'social pooling' and to create a firewall between the pay-as-you-go pillar and individual accounts. A National Social Security Fund was also established.

"But little progress has been made. Assets allocated to the individual accounts were used to pay current retirees, and the plan to finance the fund through the sale of SOE shares never materialized.

“If the present system is not changed, payroll taxes will move steadily upward. Yan Wang, an economist at the World Bank, and several other economists have calculated that tax rates would have to rise from 24 percent today to 27 percent in 2005, 45 percent in 2030 and nearly 60 percent in 2050 to bring the pension system into balance. Such increases would cripple economic growth in China.

“Another indicator of the unsustainable condition of China’s pension system is implicit pension debt (IPD)—the present value of all future benefits promised to current retirees and those still in the work force, in the event the pay-as-you-go system ended today. The World Bank estimates today’s IPD amounts to about 50 percent of China’s gross domestic product.

“To solve China’s pension crisis, the priority is to address the loss-ridden SOEs and the weak condition of the four large state-owned banks. Pension reform cannot be successful without a broad-based change in China’s ownership structure. The lack of well-defined property rights to pensions, enterprise assets, and bank capital means that China’s financial sector needs radical reform.

“The best way for China to put its pension system on a sound footing is by large-scale privatization. Implicit pension debt must be made explicit and the current hybrid system fully privatized, along with SOEs and state-owned banks. Trying to revitalize SOEs and recapitalize state banks will not do the job as long as majority ownership remains in the hands of government officials. Investment decisions will be politicized and capital will not be put to the best possible use. Corruption will continue and wealth will be squandered as special interests vie for political favors.

“In a recent article in the [Cato Journal](#), Yaohui Zhao of Peking University and Jianguo Xu of Duke University show that, under reasonable assumptions, China could pay off its pension debt and fund a private system with a total contribution rate of only 15.8 percent of payroll.

“However, that can only happen if workers’ contributions to their individual accounts remain invested and earn competitive rates of return. To be successful, pension reform must be accompanied by freedom of capital—workers must be free to choose from an array of investment options, including investing in the private sector and in foreign markets. Moreover, private-pension fund management is essential if the retirement accounts are to be free of political interference.

“If all the above assumptions hold, then workers in the nonstate sector who have no incentive to enter the pay-as-you-go system will find the new approach attractive. Their broad participation would make the lower tax rates possible. Moreover, if SOEs and state-owned banks were privatized, workers would have new investment opportunities and the proceeds from those sales could be used to fund the transition. The sale of state assets would also allow authorities to lower the payroll tax needed to finance the new system and pay off the pension debt. If a broad-based tax were substituted for the payroll tax, rates could be even lower with further gains in efficiency.

“The longer China waits to move toward a fully funded system, the more costly that transition will be. Workers will not become empowered until they have full rights to their pension funds. Privatizing the pension system would create new wealth that stays with the workers and could be left to family members or others. Workers would no

longer be tied to their firms or be wards of the state upon retirement. The private sector would grow as SOE holdings were reduced and new savings and investment poured into the most productive sector of the economy. To achieve those results, China will have to honor its commitment to the World Trade Organization to allow foreign banks to compete fully with state-owned banks by 2007, liberalize interest rates, open capital markets, respect private-property rights, and depoliticize banking and commerce.

“Several years ago Ms. Zhao argued, ‘The best alternative in solving the financial crisis is to give individuals incentives to participate. The best way to give incentives to individuals is to put all pension contributions (from both employer and employee) into individual accounts and make sure that the investment earns competitive returns. This gives individuals the property rights to these accounts.’ Once workers’ rights to their pensions are secure, they will have greater freedom and a brighter future than under the present politicized pension system. Mr. Pinera is correct when he says, ‘The world would be a better place if every worker were also an owner of capital.’

“Privatizing China’s pension system would be a giant step in the right direction. But that must be accompanied by a larger privatization program if China is to realize its full potential.”

Gokhale Warns of Entitlement Crisis

According to Cato senior fellow [Jagadeesh Gokhale](#), long-term fiscal difficulties lie ahead absent major entitlement reform. Unfunded entitlement programs such as Social Security and Medicare shift heavy costs to future generations. Not only are these programs costly in terms of money directly required from future generations, they are also costly in the damage that they cause to the economy. Gokhale suggests that private accounts for Social Security will help avoid the troubles ahead in his *Financial Times* op-ed “Tomorrow’s Generation will Foot the Bill,” which follows:

“The latest US budget numbers indicate that the deficit for 2004 will exceed Dollars 500bn (Euros 390bn), an increase of almost Dollars 150bn over 2003. This cloudy fiscal outlook prompted Alan Greenspan, chairman of the Federal Reserve, to issue a strong cautionary message this week: ‘The imbalance in the federal budgetary situation, unless addressed soon, will pose serious longer-term fiscal difficulties. One critical element—present in the 1990s but now absent—is a framework of procedural rules to help fiscal policy makers make the difficult decisions that are required to forge a better fiscal balance.’

“Mr. Greenspan’s remarks hint at the need to reintroduce federal spending and financing constraints, similar to those included in the Budget Enforcement Act of the 1990s.

“... (S)uch budget constraints alone may not be sufficient to encourage the higher saving, investment and output growth needed to prepare for the coming wave of baby-boomer retirements. A new Budget Enforcement Act would, again, be abandoned as soon as big federal surpluses re-emerged—and for good reasons. The problem is that, in the absence of constraints, the remaining budget institutions are inadequate to prevent current generations from socking it to future ones: witness the post-BEA enactment of a massive and unfunded Medicare prescription drug benefit for America’s senior citizens.

“Existing institutions fail to arbitrate a resource-allocation ‘dispute’ between living and future generations, both of which have ‘claims’ on present and future national output. While successful economies have effective systems to adjudicate property conflicts among the living, fairly arbitrating one between living and future generations is difficult, because the unborn cannot stand up for their claims. This leaves current generations free to vote large and unfunded public benefits for themselves and to bequeath massive public debts to future ones. Under current budget accounting in America, most such debt remains hidden. Less appreciated by current generations is that if they grant themselves too much by way of unfunded benefits today, they could end up winning a battle but losing a (generational) war.

“The expected impact of today’s policies on tomorrow’s outcomes will influence today’s private economic choices—especially choices made by today’s younger generations and succeeding generations as they grow up. For example, current policy decisions may imply that taxes on labour or capital will be much higher in future. In anticipation of much higher labour taxes, younger generations may choose to invest less in acquiring productive skills—because the higher salaries they would win as a result would be taxed away. Higher labour taxes might also discourage skilled immigrants. Both reactions would amplify the ‘sucking sound’ of jobs being shipped abroad. When jobs go overseas, capital is unlikely to be far behind. In addition, the prospect of higher taxes on income from capital—and therefore lower investment returns—could make it difficult for the US to attract the level of foreign capital that supports domestic investment.

“These tendencies will reduce employment and productivity, and shrink the national output available for today’s voting generations when they retire. So when today’s voters promote ever larger unfunded benefits for themselves, they may be increasing their share of overall output, but they are also reducing the pool from which it will be drawn.

“Of course, one could argue that living generations’ fear of losing the generational war will check their fiscal profligacy.

“But, unlike the war that some observers predict—in which the younger generation votes to cut benefits, while the older lobbies to raise taxes—this one will be fought covertly. It will involve younger generations making private choices in response to profligate increases in unfunded benefits by older ones. To avert the consequences of such actions, younger generations, and their successors, will have to be encouraged to behave in ways that promote growth.

“Because greater government saving is undesirable, the only remaining avenue for increasing saving and investment appears to be a private, and necessarily decentralised, system of retirement saving: an ‘individual accounts’ reform of Social Security would be a good start.

“President George W. Bush’s call for this type of Social Security reform in his 2004 State of the Union speech points in the right direction. The chances are, however, that such institutions will develop only if budget accounting reforms are passed to reveal the full extent of the debt being bequeathed to future generations.”

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