



# Social Security Choice

## ***SOCIAL SECURITY THIS WEEK***

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

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### ***At Least Three Democratic Senators Open to Individual Accounts***

Although recent media coverage has focused relentlessly on the handful of Republicans who have expressed concerns about President Bush's proposal to allow younger workers to privately invest a portion of their Social Security taxes through individual accounts, the first cracks may be appearing in the wall of Democratic opposition to individual accounts. In the last week, three Democratic senators have expressed their willingness to consider the idea.

Sen. Ben Nelson (D-Neb.) has long been considered one of the Democrats most likely to back the president's plan. After President Bush held a pro-account rally in Omaha and held private discussions with the senator, Nelson made it clear that, while he wanted to see the plan's final details, he was not opposed to the concept of individual accounts.

A few days later, Sen. Thomas Carper (D-Del.) told the Associated Press, "I don't believe that we should rule out the accounts...We have a very low savings rate in this country and clearly need to find ways to stimulate savings, and I think we should be open to a wide range of ideas and not dismiss them out of hand." Carper made it clear that he had concerns about the details of Bush's plan, warning, "I believe that if we go down that road, establishing private accounts, we should do so in a way that does not significantly increase our federal budget deficit and does not significantly cut benefits for our parents or, frankly, for our kids." However, his position makes it clear he is willing to discuss the issue.

And, most recently, Sen. Kent Conrad (D-N.D.) said, "there is a kernel of a good idea with individual accounts" as a way to get a higher rate of return on Social Security funds. Conrad said that he is opposed to individual account plans financed heavily through new borrowing, but he is open to other ideas for transition financing.

Private reports from Capitol Hill indicate that several other Democrats may be willing to consider individual accounts as part of an overall Social Security reform package. While Republicans hold a 55-45 majority in the Senate, the president will need at least 60 votes to prevent an expected filibuster. He may be closer to achieving this than mainstream media reports would indicate.

## **Greenspan Backs Personal Retirement Accounts**

Alan Greenspan spoke out on the urgency for Social Security reform this week, stating, "I've always supported moves to full funding in the context of a private account. We've got a problem in that the existing pay-as-you-go system is not working, and we've got to change it."

"These accounts, properly constructed and managed, will create ... a sense of increased wealth on the part of middle and lower-income classes of this society, who have had to struggle with very little capital," Greenspan said, according to a [Reuters report](#).

Greenspan urged caution on transition financing however, noting that taking on \$2 trillion in debt would be risky given the unpredictability of the market's reaction to such borrowing. "If you're going to move to private accounts, which I approve of, I think you have to do it in a cautious, gradual way," Greenspan said.

Several Democratic lawmakers who were on hand for Greenspan's testimony jumped on his warning to make changes gradually. Sen. John Corzine (D-NJ) claimed that Greenspan's comments were a setback for the president to overcome. But according to the [Washington Times](#), that isn't necessarily the case:

"Mr. Greenspan said even with the risk involved, creating private accounts will be a better move in the long run than the status quo.

"He said the existing Social Security system, which relies on current workers to fund the benefits of current retirees, worked fine when the ratio of workers to retirees was high and life expectancy was lower. But now, life expectancy is increasing and the ratio of 3.3 workers per retiree will continue falling as baby boomers start to retire, changes he said the present system is 'ill-suited' to handle. He estimated the unfunded liability of the system, projected out to infinity, at more than \$10 trillion.

"He said personal accounts have a good chance of providing young workers with the retirement amount they would have received if the system were financially sound.

"Personal accounts have far greater probability...of being fully funded. And the simple form of pay-as-you-go by construction saves nothing,' he said."

## **Another Nobel Laureate Supports Individual Accounts**

Writing this week in the *Wall Street Journal*, Nobel laureate in economics Gary Becker announced his support for personal accounts, support that is based on what he calls the political case for reform.

"I believe that the advantages are mainly political, not 'economic,'" wrote Becker, "and that privatization helps to separate saving for retirement from interest-group politics, from taxation, and from government spending." Although Becker doesn't explicitly state that ownership of one's retirement savings is the mechanism by which those savings are separated from the threats posed by the political process, it's clear that that's exactly what he means.

In the following excerpt, Becker elaborates on those political threats and concludes that the same arguments for privatizing other industries, such as steel, hold true for the retirement industry.

“Pay-as-you-go systems are in trouble [partially] because of politically determined decisions that altered the system from a saving system for old age to an inefficient and complicated welfare system for some of the elderly. Despite the growing mental and physical health of older persons, political pressures in all nations with such systems forced a restructuring of social security payouts to encourage retirements at earlier ages than even the originally established 65...

“In addition, the link between contributions and benefits has been separated, so that each additional dollar contributed in taxes pays no more than about 40 cents in additional benefits. Hence, the social security system has evolved into two largely independent systems: a sizeable tax on wages, starting with the first dollar earned; and retirement benefits that are ‘guaranteed’ by the government. There is only a modest link from an individual’s accumulated tax payments on his earnings to these ‘guarantees.’

“Just as important are the political implications of federal fiscal behavior. Revenue from Social Security taxes at present exceeds payments to retirees. This excess is counted as part of the growing Social Security Trust Fund, but in fact also enters into the consolidated federal budget account, and helps reduce the reported spending deficit. Reported deficits during the past decade would have been much larger if Social Security were not running a surplus during this whole time period.

“Social Security tax revenues are expected to fall below spending on retirees in less than 20 years. If we simply raised Social Security taxes now—say by two percentage points—consolidated federal deficits would appear much smaller, and the federal government would be under less constraint to reduce spending. Both theory and evidence indicate that a good fraction of the additional revenue would indeed be spent. ‘Putting aside’ assets for the future is very difficult for all governments, subject as they are to immense demands for spending now from various interest groups.

“A good individual-funded savings system would require individuals to save 4% to 6% of their incomes (President Bush suggests 4%), and to invest these savings in private individual accounts that would meet certain government-established criteria. At the same time, Social Security taxes should be cut by a couple of percentage points from the present level to ease the burden on workers. These taxes could be cut since under this saving system younger workers would be contributing to their own retirement. Moreover, a tax cut would reduce the Social Security surplus, so the government would be less tempted to spend more by rapidly growing Social Security ‘reserves.’

“These private accounts would accumulate tax-free until individuals decide to retire. The age of retirement, within broad limits, would be left to individuals; but like IRAs now, these funds would continue to grow with savings for persons who retire at later ages because they like their work, and are in good health. At retirement, individuals would get access to their assets either in a lump sum or as annualized income, and would pay taxes on their withdrawals...

“There is no guarantee that government interference would not increase further in such a privatized system since the retired would continue to press for additional benefits. But experience shows that governments interfere less when an industry is privatized, especially in access to capital and financing of budget deficits.

“So the really strong arguments for privatization are that they reduce the role of government in determining retirement ages and incomes, and improve government accounting of revenues and spending obligations. All the other issues are really diversions, because neither advocates nor opponents of privatizing Social Security generally answer the most meaningful question: Is there as strong a political economy case for eliminating government management of the retirement industry as there is for eliminating its management of most other industries?

“My answer is ‘yes.’”

### ***Economist Estelle James Examines Chile’s Pension System***

Responding to recent criticisms of the Chilean private pension system, economist Estelle James penned an in-depth commentary in the [Washington Post](#) on the pros and cons of the Chilean system and what we can learn from their experience. James gives a detailed explanation of how the system functions and how it has fared thus far. From her explanation:

“Has it been a good deal? Yes. The annual rate of return excluding fees (more on that shortly) during the first 22 years was an astonishing 10 percent above inflation—fortunate for the new system but far above the rate that any country can maintain in the long run. However, even lower returns can ensure comfortable retirements. If the rate of return falls to 4.9 percent above inflation (a figure the U.S. Social Security Administration uses as the expected return of a mixed portfolio of stocks and bonds) while wages grow at 2 percent above inflation, the average Chilean worker who contributes until he retires at 65 would get 60 percent of his final wage plus a survivor’s pension for his spouse. (Under Social Security, a middle-income U.S. worker currently gets about 42 percent of his pre-retirement earnings.)

“Of course, it’s not that simple. Higher returns entail higher risks. Financial market swings pose some dangers for retirees who rely on personal accounts. But Chile has reduced risk in several ways. Most important, it established a minimum pension guarantee, financed out of general tax revenues, for any worker who contributes to a personal account for 20 years. Every year the government has raised the pension minimum, roughly in line with wage growth. This keeps the pension floor around 25 percent of the average wage, almost double the poverty line, for retirees who earned little or use up the money in their accounts. (A lower means-tested pension exists for those who contribute for less than 20 years.) Only 4 percent of all beneficiaries collect the pension subsidy so far, but the numbers are bound to grow, and Chile hasn’t figured out the ultimate costs, or how to pay for them.”

James goes on to list several lessons that reform advocates in the United States should heed in creating a similar system. The following excerpt discusses those lessons.

“What are the downsides to Chile’s scheme? What should we do differently here?”

“First, workers in Chile had practically no investment choice for 20 years. Each asset manager could offer only one portfolio and portfolios were all similar. A young worker might have wanted to make riskier investments than an older worker, but that wasn’t an option. Chile recently modified its rules to enable each asset manager to offer five portfolios, with different degrees of risk. But now some low earners game the system and choose the riskiest investments, hoping for big gains while knowing that the government will give them the minimum pension if the risk does not pay off.

“If we create personal accounts in the United States, we should also make portfolio choices simple, limited and diversified—including international securities—to protect inexperienced investors from themselves.

“Second, Chile’s system initially had very high administrative costs, in part because fund managers had to invest in new information technologies and marketing tools. As assets grew, costs fell dramatically and are now about 1 percent of assets, lower than in the average U.S. mutual fund. Over a lifetime, costs in Chile are projected to reduce a worker’s final pension by 15 percent. In the United States, we can do better. We can enjoy economies of scale and the bargaining power obtained from aggregating many small accounts into enormous sums. For example, we could auction off the rights to run the funds to a limited number of asset managers, which would push down their fees. We could require the use of index funds and collect contributions through the existing tax collection system. The experience of the retirement plan for federal civil servants suggests that these techniques would cut our costs to about one-third of those in Chile.

“Third, Chile allows workers to stop contributing and start withdrawing once they meet a certain threshold. Most workers qualify before age 60, some even before 50 -- and they have taken their annuities as soon as they can. Eventually many retirees will qualify for subsidies when the government’s minimum guarantee overtakes their annuities. (Taking the pension does not mean you must stop working. In fact, Chile encourages pensioners to continue working by exempting them from the payroll tax. This is good for their incomes and the economy.)

“Fourth, Chile’s minimum pension is good, but could be even better. On the plus side: It keeps low-income pensioners from falling way below the average standard of living. On the negative side: It offers no extra safety net for more than 20 years of work. Some low earners avoid contributing beyond 20 years because their additional contributions would simply replace subsidies they would get otherwise. In the United States, we could avoid creating such perverse incentives.”

## **Washington Post Editorial Explores Potential Benefits of PRAs**

As part of a series on Social Security reform, the [Washington Post](#) ran an editorial last week expressing cautious optimism about the president’s proposal to allow workers to divert four percent of their wages—about 1/3 of the payroll tax—into personal

retirement accounts rather than the traditional Social Security system. The editorial follows.

“Whether Social Security is in ‘crisis’ or not, everyone agrees that the system faces a deficit. There is less agreement, however, on whether the personal Social Security accounts advocated by President Bush in the State of the Union speech would reduce the funding problem. The administration’s critics have seized on comments in a briefing given by a senior official: ‘Personal accounts would have a net neutral effect on the fiscal situation of Social Security,’ the official conceded. Armed with such quotations, Mr. Bush’s opponents accuse him of pushing an irrelevant non-solution for ideological or political reasons.

“But the quotations have been taken out of context. It’s true that personal accounts, by themselves, would not reduce Social Security’s deficit. Mr. Bush’s proposal gives workers the option of diverting part of their Social Security taxes into personal accounts; in return, workers who exercise that option accept a cut in future payments from the traditional Social Security system. This exchange is designed to be financially neutral for the government: hence the official comments. But this doesn’t mean that personal accounts have no impact on Social Security’s solvency. By investing partly in stocks, personal accounts would boost benefits for the average retiree—and hence make it politically easier to take the tough steps necessary to fix the solvency problem.

“To see how this might work, consider analysis by the Social Security Administration’s nonpartisan actuaries. The actuaries have worked out what would happen if, as the president suggests, individuals were allowed to divert as many as 4 percentage points of their payroll taxes into personal accounts. The average worker retiring in 2075 under these rules would have accumulated personal savings sufficient to generate a monthly pension worth half of her currently scheduled benefit. In return, she would have accepted a cut from the traditional Social Security system; under the terms announced by the administration last week, this would be worth 30 percent of her scheduled benefit. The difference—a profit to the individual equivalent to a fifth of the scheduled benefit—would cushion the shock of any separate benefit cut imposed to fix the solvency problem.

“This profit exists because equities outperform bonds over the long term. Under the current system, payroll taxes reduce the government’s borrowing requirement, so the effective ‘return’ on Social Security savings is the government bond rate, which the Social Security actuary projects to be 3 percent above inflation. Personal accounts, by contrast, could be invested in a mix of assets; on the assumption that they were 50 percent in stocks, 30 percent in corporate bonds and 20 percent in government bonds, the Social Security actuary projects that the return after administrative costs would be 4.6 percent above inflation.

“Even though these projections are produced by nonpartisan scorekeepers, the administration’s critics claim that the promise of extra returns from personal accounts is somehow illusory. They argue that, if investors are rational, there can be no real ‘equity premium’: The proposition that you can conjure up money by shifting Social Security resources into equities presupposes that the sellers of those magical equities are idiots.

Yet equities are a good bet for retirement savings not because the sellers of equities are dumb but because retirement plans, which have long horizons, can absorb the volatility of equities better than most investors.

“The critics also argue that mass Social Security purchases of equities will drive their prices up. So even if equities are a bargain at the outset, they soon won’t be. But Social Security purchases of equities would not be big enough to trigger serious price moves in the nation’s extremely deep and liquid capital markets. Goldman Sachs researchers recently noted that annual equity accumulation by personal account holders would peak at 0.6 percent of the value of the market. That modest spike in demand for equities would be swamped by potential swings in the supply. In some years over the past two decades, firms have issued new equity worth as much as 2.5 percent of the value of the market. In other years, share buybacks have reduced the supply of equity by as much as 4 percent.

“In short, the equity premium is real even though its precise size is unknowable; it amounts to a strong argument in favor of personal accounts.”

The editorial concludes by bringing up the subject of the risks of reform, which will be covered in the next editorial in the series.

### **Post’s Robert Samuelson Spins Lack of Ownership to be a Good Thing**

Columnist Robert J. Samuelson used a novel argument against personal retirement accounts in his *Washington Post* column this week. He wrote:

It may shock most Americans to know that Congress could legally cut or eliminate their Social Security benefits tomorrow. But that’s also the White House position. Dig deep into its budget documents, and here’s what you find: “Future Social Security...benefits may be considered as promises or responsibilities of the Federal Government, but these benefits are not a liability [debt] in a legal or accounting sense.... There is no bright line dividing Social Security...from other programs that promise benefits to people.” Well, this flatly contradicts the administration’s logic that Social Security is a future debt that must be paid. If it can borrow tons of money for personal accounts, it can borrow tons for future food stamps or Medicaid.

Samuelson essentially argues that because we have no legal right to our Social Security benefits, claims of an unfunded liability ring false. But whether the government plans to give the money back through scheduled benefits or not, the surpluses have been converted into Treasury bonds and represent real debt that the government owes, regardless of who it is owed it to, unless Mr. Samuelson is suggesting that the United States government will simply default on its Treasury bonds.

Furthermore, personal retirement accounts aren’t meant to solve the financial problem of Social Security; they are meant to make the solution less painful. Samuelson says the government can and will cut benefits or raise taxes whenever it wants to—yet he

doesn't arrive at the logical conclusion that personal retirement accounts would make the results of those changes less devastating to ordinary working Americans.

Samuelson's column contained one of the most deceptive arguments against PRAs yet: The government could just stop providing benefits, and poof! No unfunded liability, no problem. But there is a problem. There's no silver lining around the fact that Americans don't have a property right to their Social Security contributions; the lack of ownership is perhaps the biggest problem of all with the current system.

### ***Upcoming Events***

Next Wednesday, February 23, the Family Research Council will host a lecture entitled "Making Social Security Reform Family-Friendly." The luncheon lecture will feature Allan C. Carlson, author of the recent book *Fractured Generations: Crafting a New Family Policy for 21<sup>st</sup>-Century America*. For more information and to register, click [here](#).

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