



Social Security Choice

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

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Cato Institute Releases New Book on Social Security Reform

Social Security is facing irreversible demographic and fiscal pressures that threaten future retirement benefits for today's young workers. In 2008, just four years from now, the first members of the baby-boom generation become eligible to receive Social Security benefits. Within the next 14 years, the number of beneficiaries will turn the program's financial surplus into a deficit. By 2018 Social Security will be in the red, paying out more in benefits than it takes in through payroll taxes.

In a new book from the Cato Institute, [Michael D. Tanner](#) brings together the giants in Social Security reform, including Harvard University professor Martin Feldstein, Nobel laureate Milton Friedman, former CBO director June O'Neill, and former Chilean minister of labor José Piñera. [Social Security and Its Discontents](#) examines in a single volume the fatal problems of the current system and offers concrete proposals for reform.

This authoritative collection continues the Cato Institute's efforts over the past 25 years to give workers a choice in how they invest for their retirement. *Social Security and Its Discontents* is part of Cato's Project on Social Security Choice, which includes other books and policy studies, a community leader's guide, and a course of study at Social Security University. The book is currently available for purchase online at the [Cato Store](#).

AEI's Kevin Hassett Warns about Government Investing

[Writing in USA Today](#), Kevin Hassett, director of economic policy studies at the American Enterprise Institute, outlines the problems encountered when governments involve themselves in pension plans. Apart from depriving workers of ownership over their own savings, giving money to governments for state-run pension programs invites abuse of those funds, particularly when governments use the funds to intervene in private businesses. In his op-ed, which follows, Hassett points out that abuse of this sort in California and Minnesota run contrary to the spirit of a free society.

“The American economy has been a wonder because we have constrained capricious government intervention into private enterprise. State pension funds are messing with our formula for success.

“The biggest economic failures of the 20th century were the communist countries that ceded ownership of capital to the government. Others, such as Japan, suffered because their financial sectors were heavily influenced by politicians. Corrupt officials steered loans to businesses that made the highest campaign contributions rather than to those that had the best ideas. Japan is still trying to fix the mess that ensued.

“Socialism is bad medicine in large or small doses. Which is why the recent actions of state pension funds, especially the California Public Employees’ Retirement System (CalPERS), are so troubling. Our Founding Fathers rightfully designed a system wherein the government can affect business activity through laws and regulations. If something, such as pollution, is found to be harmful, then lawmakers use the democratic process to propose laws that constrain businesses.

“California state Treasurer and radical CalPERS board member Phil Angelides, a Democrat with gubernatorial ambitions, ignores this proud tradition. His idea is for CalPERS to invest its \$166 billion in public money in a targeted way, buying up enough shares of some companies to have a significant voting block. He can then use that power to force policy changes.

“This power is being abused. For example, in California, Safeway has been in a conflict with its unions. The high union wages have put pressure on the company’s profits, and management has taken a tough line. Angelides has stepped into the fight to oppose the election of key board members. Organized labor is perhaps the largest supporter of Angelides’ Democratic Party. Are the two facts unrelated?

“Angelides is not alone. Republican Minnesota Gov. Tim Pawlenty recently used the Minnesota State Board of Investment, which owns \$467 million in Pfizer stock, to pressure the firm to make policy concessions.

“Angelides, Pawlenty and others like them appear to have a simple plan. They would grab control of large public pension funds, then dictate to our companies. Woe be unto the company that disappoints the politician. This is unacceptable in a free society.”

Such abuses at the state level should serve as a warning to those who advocate allowing the federal government to invest Social Security funds on behalf of workers. For more information on the dangers of allowing such a scheme, see Michael Tanner’s “The Perils of Government Investing,” Cato Briefing Paper no. 43, December 1998.

Alan Reynolds: Social Security Taxes Can Be a Disincentive to Work

In a commentary in Monday’s *Investor’s Business Daily*, Cato senior fellow Alan Reynolds points out a sure-fire way to beat burdensome income, Medicare, and Social Security taxes: work less and earn less. Using his own experience as an example, Reynolds points out that the current tax system, including Social Security taxes, actually

presents current workers “approaching the ripe side of mature” with a *disincentive* to earning and working. Tax penalties that create incentives to stop working will certainly put an added strain on the Social Security system, Reynolds adds. The text of Reynolds’ commentary follows:

“I have discovered a fool-proof strategy for beating the income tax, the Social Security tax and the Medicare tax: Lower your income.

“Lowering your income is much easier than increasing your income. And it helps you avoid the nasty traps Congress sets to catch those foolish enough to earn too much money—phasing out deductions and exemptions, selectively repealing deductions with an alternative minimum tax, limiting the share of income you can put away in a 401(k) plan, and denying eligibility for tax-financed benefits such as student loans and scholarships.

“Lower your income, and these problems disappear. To do this comfortably, it helps to have some savings. This game is best played by previously industrious but frugal people who are now approaching the ripe side of mature.

“Like others in that group, much of my income comes from past savings and some from work. Income from work is the easiest to tax and measure. Since 1991, when Congress turned Medicare into another income redistribution scheme, every dollar we earn from working is now taxed to shore up Medicare for a few more years. ‘Taxed Medicare Earnings’ in your Social Security statement provide an excellent measure of earnings from work.

Got Out Early

“When I looked back at my own earnings, I saw that I had already started cutting my labor income by 26% in 1998–99 by greatly reducing extra writing and speaking. The resulting savings in taxes was much greater than 26%, of course, because marginal tax rates rise with income. Uncle Sam took the biggest hit, as planned.

“My wife got this message even earlier, responding to the 1991 tax increase by retiring a dozen years short of normal. All her income would otherwise have been taxed at my steep rate.

“By not working she also stopped paying the increased Social Security tax, and later began collecting Social Security benefits at 62. Because I continue working, however, 85% of her modest benefits are taxed at my marginal tax rate. Another incentive to work less.

Federal Orders

“After the market began to tumble in March 2000, I rapidly liquidated stocks and thus ended up reporting a one-time surge in capital gains. Although most gains were taxed at a reasonable rate, they were nonetheless included in total income for the purpose of figuring out how all other income is taxed.

“As a result, every dollar of my middling labor income was taxed at the highest possible tax rate. With the U.S. government practically ordering me to work less, I promptly cut my labor income by another 27% in that year alone. I did that by shutting down a consulting business I had run for 10 years.

“The IRS, which had been collecting about 30% of my consulting income, was then collecting 40% of nothing.

“By 2003, I had managed to reduce my labor income another 36% by asking my employer to pay me less in return for less time in the office. Altogether, I have cleverly reduced my taxable labor income by 67% from 1997 to 2003. My Medicare tax likewise fell by the same amount, and the Social Security tax fell nearly as much.

“Past efforts to tax my wife and me more ruthlessly in 1991–93 had the opposite effect. Yet Sen. John Kerry now imagines he can compel us to fork over a much larger share of investment income by reverting to taxing dividends at ordinary income tax rates.

“Ironically, that would cut my taxes, not raise them. I have only lately begun for the first time to accumulate dividend-paying stocks and funds. If I ever believed dividends would again be taxed at rates of up to 39.6%, as Kerry proposes, I would rush out of dividend-paying stocks and back into tax-exempt bond funds. Instead of collecting 15% of something, the IRS would then be collecting at least 30% of nothing.

Gets Worse

“For brave souls who keep working past 65, federal work penalties grow even more severe. Such heroic Americans must keep paying into Social Security and Medicare even though those payments add nothing to their benefits.

“This is the government’s ‘nothing for something’ plan for working seniors. Even a middling salary will also result in 85% of their Social Security benefit being taxed, while those who avoid work commonly get tax-free benefits.

“To make matters worse, money taken out of IRA or 401(k) plans will normally be taxed at a higher rate if seniors keep working, because income from work puts them in a higher tax bracket.

“The sensible solution is to stop working at 62–65, or to work as little as possible—like running a 12-cylinder engine on four cylinders.

“Yet this is a dangerous message to send to our rapidly aging population. Future growth of tax revenues, and of the economy, will be heavily dependent on whether older Americans choose leisure over work.

“Between 2000 and 2020, the population between the ages of 25 and 54 is projected to increase by only 3% while the population over 55 increases by 63%. If older people shun work, there will be virtually no growth in the labor force aside from immigration. America's medium-term challenge is not a shortage of jobs but a prospective shortage of willing and able workers.

Squeeze On Revenues

“Even if only a fraction of future seniors respond in the ways I have to tax penalties on work, money flowing into the Treasury, Social Security and Medicare from an aging work force will slow even more than expected.

“A few years ago, the Russell Sage Foundation (which routinely bankrolls egalitarians) sponsored a collection of papers turning Ayn Rand’s opus into a question, ‘Does Atlas Shrug?’

“The authors could not get the right answers because they did not ask the right questions. Work effort cannot be measured by hours on the job. Work effort is more like a dimmer switch than a light switch; we adjust it by degrees. And mature, educated taxpayers are not docile sheep but wily foxes. When tax collectors set out to punish extra effort and investment, we get the message.”

Arnold Kling Discusses the Philosophy behind Private Accounts

Tech Central Station editor Arnold Kling questions the sensibility of Social Security’s current structure from a libertarian perspective in his article, “[What’s Wrong with Social Security?](#)” Countering the arguments of Social Security expert Peter Diamond, Kling argues that Social Security’s economic distortions and the impending financial crisis make the program a hefty liability unworthy of its costs. This situation can only be reversed by major reform, specifically, private accounts.

Kling responds to Diamond’s argument that Social Security is necessary because people may make poor decisions with their money, and also notes the “loss of well being” attributable to market intervention. He then concludes that Diamond’s defense of Social Security’s structure simply doesn’t add up. In the following excerpt, Kling discusses the problems inherent in Diamond’s paternalistic and utilitarian arguments in favor of Social Security as it currently exists.

“In ‘[What’s Wrong with Paternalism?](#)’ I wrote that the case against paternalism has three layers. Diamond glides right past the pure libertarian layer, which argues for giving people freedom of choice on principle. Instead, he says, ‘To my mind, the heart of the context for thinking about Social Security is that it substitutes for poor decision making and for missing insurance opportunities...Mandating savings makes sense if you think that many workers would not provide themselves a reasonable replacement rate.’

“To a libertarian, just because you believe that people save too little for their own good does not mean that ‘mandating savings makes sense.’ Even those of us who are far from pure in our libertarianism ought to at least pause and reflect about the issue of a mandatory program. Could we instead have a voluntary program, particularly now that workers have had a chance to observe the benefits of Social Security for their own parents? Could we encourage savings through incentives rather than by force? Could we just lead the horse to water, but if he chooses not to drink, leave him alone?

“The second layer of the case against paternalism is utilitarian, meaning the loss of well-being that results from interfering with the market. In the case of Social Security,

the tax and benefit structure lowers output by distorting decisions that individuals otherwise would make about labor, leisure, saving, and consumption.

“Several years ago, economist Martin Feldstein estimated that these distortions cost the economy [5 percent of GDP per year](#). This sort of analysis is sensitive to modeling assumptions, and many economists would argue that the 5 percent figure is too high. However, Diamond does not even discuss the issue. He simply focuses on whether a typical individual ought to be happy or unhappy with the structure of the program, ignoring the aggregate loss of output. Since the utilitarian issues are the heart of Diamond’s (or anyone’s) economic analysis, I will focus more on his arguments below.

“The final layer of my case was the Public Choice argument, which is that even if a philosopher-economist-king could know the optimal policy, we are governed by flawed human beings. Ironically, Diamond uses this anti-paternalistic argument to *defend* keeping Social Security’s basic structure intact. He writes, ‘I think that much of the apparent appeal of radical reform lies in the implausible implicit assumption that such a reform will pass into legislation untouched by political hands...A major reason for my concern about radical reform is the potential for ill-advised design, driven by political ideology rather than a realistic assessment of likely outcomes.’

“Diamond has made a valid point. I sometimes think that the cliché ‘If it ain’t broke, don’t fix it’ could be amended to add, ‘...And even if it is broke, don’t underestimate the ability of Congress to break it even worse.’

Cutting Diamond

“It is time to cut into the core of Diamond’s argument in favor of Social Security. He makes a utilitarian case for Social Security’s three salient features:

- Social Security is mandatory, rather than voluntary.
- Social Security recipients are forced to accept an annuity, without the option of taking their retirement benefits as a lump sum.
- Current recipients’ benefits come from current workers’ tax payments, rather than from the recipients’ own previous tax payments.

“Diamond believes that in the absence of Social Security, workers would fail to save enough for retirement. He says that many have inadequate savings even with Social Security, therefore clearly they would be in trouble without it. He writes, ‘Excessive reliance on Social Security [is] the best evidence for evaluating whether workers make adequate preparation for retirement.’

“Diamond gives the following as a basis for his claim that the elderly rely excessively on Social Security:

‘One-third of the elderly received at least 90 percent of their income from Social Security in 2001 [even though the] average new award for a retired worker in 2002 was just over \$900 per month...a worker retiring in 2002 at age 62 (the modal retirement age)...received a benefit of roughly one-third of (wage-indexed)

lifetime average earnings...you would not want to retire on one-third to one-half of what you had earned on average in your lifetime.'

“Concerning Diamond’s point that Social Security constitutes a large portion of the income of many elderly, it is worth noting that the assets owned by the elderly may not produce much in terms of reported income. A \$250,000 house that is appreciating at an annual rate of 5 percent would be counted as not producing any income, even though the appreciation is worth \$12,500 per year. (We also should count the rental value of the home—the value of housing services—as income.)

“A \$300,000 stock portfolio might produce reported dividend income of less than \$3000 per year. Most of the income from stocks comes in the form of capital gains, which might not be reported in the study that Diamond was using. If capital gains and losses were included in the income measure on which he relies, then they *reduced* income in the year 2001 that he cites, because it was a down year for the market. It seems safe to say that one way or the other the estimate of income from stock market portfolios in 2001 was much lower than the average stock market income over the past thirty years.

“The supposed inadequacy of savings is contra-indicated by Diamond’s incidental mention that more people retire at age 62 than at any other age. If you had reached age 62 without adequate savings to live on, why would you retire? Your Social Security benefits are much lower at that age than would be the case if you worked another few years.

“Another contra-indication is the dismal reception in the marketplace for [reverse annuity mortgages](#). For years, mortgage lenders have been drooling over the prospect of making mortgage loans to low-income elderly. The small number of takers suggests that the elderly are not as desperate for cash as the lenders were hoping.

“I should make it clear that I believe that the phenomenon of elderly people who have not provisioned themselves adequately for retirement is real. But the question is how widespread is the problem—are we talking about 5 percent of the population or 50 percent? Diamond failed to provide convincing evidence that the larger number is a better estimate than the smaller one.”

LA Times: Policymakers Can Learn Much From Latin American Pension Reforms

Though policymakers in the United States have been slow to respond to the urgent need for Social Security reform, they could learn much about the process by studying the reform efforts in Latin America, writes Marla Dickerson of the *LA Times*. [Her article](#) in the *Times* this week suggests that there are a number of pitfalls to be avoided as reform of Social Security gets underway in the United States, including the unrest created among heavily unionized government workers faced for the first time with having to carry the bulk of the burden for their own retirements. The following excerpt identifies the problems with Latin American pension reform, but suggests also that doing nothing to reform Social Security in the United States would prove a much worse alternative.

“Latin America is a recognized leader in social security reform. But lately the golden years there have been anything but.

“Federal employees across Mexico have staged massive demonstrations to challenge government efforts to ax their pension benefits. Leaders in Brazil and Argentina are under fire from workers angered by cutbacks in their retirement funds.

“These frictions are cautionary tales for the U.S. as it struggles to fix its stressed Social Security system. One clear lesson: Reforms are inevitable, but they will undoubtedly cause unrest.

“Beginning with Chile in 1981, Latin governments that had promised retirees more than their struggling economies could deliver were forced to make radical changes that the U.S. and many other developed nations so far have ducked.

“While U.S. policymakers debate the merits of partially privatizing Social Security, as well as cutting benefits and raising the eligibility age, nearly a dozen Latin nations have already retooled their rickety publicly financed systems with individual savings plans that require workers to finance at least a portion of their retirements.

“Mexico in 1997 forced all private-sector employees to tuck part of their salaries into personal 401(k)-style accounts. But an effort to extend those reforms to government workers recently hit a roadblock, as civil servants took to the streets to protect their publicly financed pensions.

“Tens of thousands of unionized federal medical workers jammed city centers in Mexico City, Guadalajara, Monterrey and Cuernavaca this month to protest government proposals to raise their retirement age and move them toward funding the lion’s share of their own pensions, like their counterparts in private industry.

“‘Our union fought hard for these benefits,’ said 40-year-old Ricardo Lopez, a nurse in Mexico’s vast public health system who joined an estimated 60,000 protesters in Mexico City’s central plaza. ‘We’re here today to show [Mexican President Vicente] Fox that if he wants to fight, we’re ready.... We’ll strike if we have to.’

“Such talk is being dismissed as mere posturing. But it illustrates how difficult and divisive social security reform remains in the region that pioneered the trend two decades ago.

“Change hasn’t been smooth or easy. Like Mexico, other Latin American countries are finding that pension reform isn’t a one-time quick fix but a long-term process fraught with obstacles. These countries continue to grapple with the question of how to provide for their seniors without crushing taxpayers, shortchanging other social programs or stunting economic growth.

“Some nations are struggling under two-tier systems that kept previous benefits intact for older workers with no clear way to pay for them. Others are bedeviled by large and growing underground economies that siphon off workers who could help pay some of the freight. Others didn’t make needed changes to other parts of their economies that were necessary for pension reform to succeed.

“The lesson is that not all reforms are created equal,’ said L. Jacobo Rodriguez, a financial services analyst at the Cato Institute in Washington. The U.S. ‘could learn a lot by watching our neighbors,’ he said.

“There has been plenty to watch:

- Brazilian President Luiz Inacio Lula da Silva in December won approval of legislation to deflate ballooning pension benefits for state workers, who typically retired with full salaries plus cost-of-living adjustments. In the process, the leftist leader angered some of the people who had swept him to power as part of a popular revolt against conservative economic policies.
- An unemployed Bolivian miner, distraught over the government’s refusal to return what he had paid into the state pension system, strapped on dynamite and blew himself up inside a federal building in La Paz last month, killing two policemen as well. The deaths focused attention on the plight of thousands of other Bolivian workers who have been stiffed on retirement benefits due in part to a gap in coverage between the old state pension plan and the private system that Bolivia created in 1996.
- Workers in Argentina saw the value of their personal retirement savings accounts plunge in 2002 after the nation devalued its currency and defaulted on government bonds held by private-sector pension funds. The government has offered to settle its debts for the equivalent of 25 cents on the dollar, enraging workers who have been required to contribute to these individual savings plans since 1994.

“These conflicts underscore the tough work that lies ahead for the United States. Federal Reserve Chairman Alan Greenspan caused a tizzy in February when he called for reducing Social Security benefits and raising the retirement age.

“Without changes, the Social Security system is expected to be insolvent in less than 40 years, as the retirement of 77 million baby boomers swamps the program’s finances.

“Some conservative policymakers, including those in the Bush administration, have proposed that workers be allowed to divert some of their Social Security taxes into private investment accounts. Some Democrats and others argue that such privatization would be too risky.

“And some observers worry that the dust-ups surrounding pensions in Latin America could discourage the U.S. from doing much of anything.

“But analysts such as Anita Schwarz, an economist and pension expert with the World Bank, said the headlines coming out of Latin America should motivate developed nations to act decisively rather than back away from change.

“Although social security restructuring has had mixed success in Latin America, and some reforms have been downright botched, the consequences of doing nothing have typically been worse, Schwarz said.

“The bottom line, she said, is that traditional social security structures can’t handle the demographic changes sweeping the globe. Doing nothing only ensures that inevitable changes become more painful the longer they’re avoided, Schwarz said.”

Publications

The Heritage Foundation recently released a Backgrounder paper on the Social Security reform debate entitled “[Providing Social Security Benefits in the Future: A Review of the Social Security System and Plans to Reform It.](#)” The paper, written by David C. John, compares various proposals by Representative Jim DeMint (R-SC), Senator Lindsay Graham (R-SC), Representative Nick Smith (R-MI), Peter Ferrara, and Peter Orzag and Peter Diamond.

The Social Security Administration has released its latest publication of the newsletter “[International Update.](#)” The publication for the month of April looks at the most recent international developments concerning pension reform. In this month’s issue, movements toward reform in Germany, Italy, Australia, China, Canada, Chile, and Peru are discussed.

[The Retirement Project at the Urban Institute](#) recently released the brief “Social Security Reform and Benefit Adequacy,” by Lawrence H. Thompson. The paper discusses the implications of changes to Social Security—an increase in the retirement age and a reduction in benefits, specifically—on lower-income workers, who rely more on their Social Security benefits in retirement than higher-income workers.

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