



Social Security Choice

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

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Lessons to Learn from “Old Europe”

If America wants to know what things will be like without real Social Security reform, all it needs to do is look at Europe’s pension systems today. In an op-ed appearing Wednesday, May 14, in the *Washington Times*, William G. Shipman argues that we should learn from Europe’s example of government pension struggles. The op-ed, “‘Old Europe’ Getting Older,” follows:

“During the diplomatic run-up to the war with Iraq, Defense Secretary Donald Rumsfeld introduced the term ‘Old Europe’ to punctuate the opposition of Germany and France to the use of force in the impending conflict. In retort, French government spokesman Jean-Francois Cope offered: ‘An ‘old’ Continent...can sometimes be infused with a certain wisdom, and wisdom can sometimes make for good advice.’

“The epithet ‘Old Europe’ has another meaning, one that will be more determinate of the Continent’s future than any perceived cultural advantage or inherited wisdom. Europe’s population is aging: People are living longer, women are having fewer children, and the number of workers relative to retirees is shrinking. These trends will cause their Social Security systems and, more generally, the welfare state part of Europe’s DNA to collapse. Old Europe, as we know it, is dying.

“The beginnings of the welfare state were introduced by Germany’s Chancellor Otto von Bismarck in 1889 when he adopted what is now called Social Security. Over the following years and decades many other nations, including the United States, followed his lead by also offering government benefits in large part to replace income lost to old age, disability, sickness, death, work injury and the like. As time progressed, the benefits became significant, as did their costs.

“In most cases these benefits are financed with a payroll tax, using what is often referred to as pay-as-you-go financing. In such systems benefits for today’s elderly are paid by taxing today’s young. And benefits to be paid to today’s young will be financed by taxing tomorrow’s young. This system is a simple transfer of wealth from young workers to older retirees. There is no saving or investment of resources for future economic growth.

“For both taxes and benefits to remain reasonable, for the financial structure to remain stable, it is necessary that there always be many workers to tax relative to those

who are benefit-eligible. This ratio of workers to beneficiaries is determined mainly by two variables: life expectancy and the birthrate. In Old Europe, both are moving in a direction that upsets this stability.

“The combination of rising life expectancy and falling birthrates results in a fall of workers relative to benefit-eligible retirees. According to the IMF, the ratio of contributors to retired beneficiaries in 1995 for France and Germany was 2.5 and 2.3, respectively. They have been on a steady decline and over the next five decades they are expected to drop to 1.4 and 1.2.

“The political response to such a demographic squeeze has often been an increase in the payroll tax rate on the shrinking—relatively, that is—work force.

“In the United States, for example, the employee and employer combined Social Security tax in 1950, when there were 16 workers per beneficiary, was 3 percent on a wage limit of \$3,000. This year, with only 3.3 workers per beneficiary, it is 12.4 percent on \$87,000. The maximum tax has jumped from \$90 to \$10,788. By European standards, however, it is low. The payroll tax in France is 49.3 percent, Germany is 40.9 percent, Italy and Spain are 42.5 and 37.8 percent, respectively.

“How ‘Old Europe’ deals with these realities will largely determine its destiny. The elderly are absolutely dependent on institutions that are fundamentally, and demographically, unsound. The tax burden on workers is prohibitive causing avoidance in many forms including earlier retirement that further stresses the system.

“Europe’s economies and institutions are at risk. And yet, part of Europe’s culture, the welfare state broadly defined, is a hard-wired reality of the region. Something will have to give.

“Mr. Rumsfeld’s characterization, ‘Old Europe,’ raised the ire of some of our European partners who responded that Europe’s long history gave it a wisdom that a relatively young United States could not yet have acquired. Maybe so. If that is the case, it will need to harness that wisdom to solve an extraordinary challenge it can no longer avoid.”

Shipman is chairman of Carriage Oaks Partners LLC and co-chairman of the Cato Institute’s Project on Social Security Choice. For more information, see his recent paper, [“Retirement Finance Reform Issues Facing the European Union.”](#)

Personal Retirement Accounts Narrow the Wealth Gap

Jason M. Thomas, economic policy analyst at the U.S. Senate Republican Policy Committee, presents Social Security personal retirement accounts as a tool for widespread wealth accumulation. His new paper, [“A Nation of Owners and Savers,”](#) argues that, while the current system discourages savings and limits flexibility, personal retirement accounts would narrow the wealth gap by allowing everyone to acquire financial wealth.

Thomas clarifies that the wealth gap, believed by some to be due solely to income disparities, is due to African Americans being “much less likely to invest in stocks...than whites at all levels of income. As long as African Americans invest less in wealth-

generating assets, such as stocks, mutual funds, and bonds, income growth alone will not close the wealth gap between races.”

Thomas explains that while Social Security was originally enacted as longevity insurance, with the average life expectancy of a retiree much shorter than 65 years, over time it became a retirement plan. Increased life expectancy transformed the program from one with low up-front costs and few beneficiaries to “a federally enforced retirement-savings program with high up-front costs and many beneficiaries.”

Social Security’s OASI program offers no choices about saving for retirement, and its benefit structure results in African Americans, with their shorter life expectancy, subsidizing whites, according to Thomas. Furthermore, benefit calculations increase the wealth gap since they take into account only the 35 years of highest indexed income. African Americans are more likely to enter the work force before completing of high school or earning an undergraduate degree than are whites. Another contributor to the wealth gap is the fact that African Americans receive less in inheritance and gifts than do whites.

While some people argue that the current Social Security program should not be changed because it disproportionately benefits African Americans through disability and survivors’ programs, Thomas explains that “there is no reason to conclude preemptorily that personal retirement accounts would reduce the funds available for either program.”

Thomas argues: “Social Security has evolved since its implementation to extract more resources from workers for far less in return. This has negatively affected blacks relative to whites because blacks’ shorter life expectancy and lower median income. Instead of addressing future cash-flow shortfalls with further payroll tax increase that will not exacerbate the wealth gap, Congress should consider changing Social Security’s retirement benefit component from its current ‘longevity insurance’ model to one based, at least in part, on personal savings and retirement accounts.”

Thomas concludes: “[It] is clear that the difference in asset ownership rates is the biggest contributor to the wealth gap. It is now up to the policymakers to take the steps necessary to help non-investors join in the dynamism of the U.S. economy through OASDI modernization that could allow all American households to build an estate and narrow the wealth gap in the process.”

Social Security Delay Heightens Political Stake

An ongoing war on terrorism and a muffled economy would seem likely to have severe political repercussions in the coming elections. However, Leanne Abnor, president of [For Our Grandchildren](#), and former Cato Social Security analyst Andrew Biggs cite polling results that claim otherwise. President Bush and members of Congress, they claim, will have more political capital at stake if they continue to delay on promised Social Security reforms. Excerpts of their recent op-ed, “Social Security Poll: Voters expect results,” follow:

“You don’t hear as much about Social Security reform these days, with most of our attention going to the economy and winning the war on terrorism. Nevertheless, poll results show that Americans won’t let President Bush and the Congress get away with

ignoring Social Security reform. Amidst all else, American citizens expect the President to follow through on his pledge to fix our flagging Social Security program.

“Social Security is a ‘pay-as-you-go’ program, which means that the benefits collected by today’s retirees are funded with taxes paid by today’s workers. Nothing is saved or invested for the future. That worked fine when life expectancies were short and the Baby Boom flooded the labor force with new workers. But as the Baby Boomers retire and life expectancies increase, Social Security’s financing will struggle. Over the next several decades the program’s benefit obligations will increase by 50 percent as a share of the total federal budget, far beyond what its tax revenues can support. Clearly, something must be done, and soon.

“President Bush recognizes this. He campaigned on the idea of letting workers invest a portion of their Social Security taxes in personal retirement accounts, similar to IRAs or 401(k)s.

“But the events of September 11, 2001, and the floundering economy have seemingly distracted President Bush’s attention. While he appointed a blue ribbon reform commission in 2001 that included former Democratic Sen. Daniel Patrick Moynihan, Bush has yet to act on their personal account proposals. Some lawmakers and political consultants are reluctant to tackle the issue at all, thinking the ‘third rail’ of politics will deliver them a political shock. In fact, a new post-election poll shows that the jolt may come if lawmakers don’t address Social Security.

“The prestigious polling firm of Zogby International conducted state level polls gauging likely voters’ concerns on a variety of issues. The importance Americans place on Social Security reform may surprise you.

“Zogby asked how likely voters would rate President Bush’s job, if after two years the war on terrorism has been won but Social Security reform had not been signed into law. Overall, roughly 40 percent of Americans would give Bush an ‘excellent’ or ‘good’ job rating, while half would judge him only ‘fair’ or ‘poor.’

“By contrast, if after two years the war on terrorism continued but Social Security reform has been signed into law, the numbers are nearly reversed: roughly 55 percent would judge Bush ‘excellent’ or ‘good’, and around 35 percent ‘fair’ or ‘poor’.

“Voters seem to realize that the President has limited power to totally defeat terrorism or fix the economy. The President can, however, follow through on his promise to fix Social Security.”

Spousal Benefit Formula Detrimental to Working Women

“At-home mothers are seeking ways to increase their Social Security benefits, but working married women are the largest group to be treated unfairly under the current system, economists agree,” [writes](#) Peggy O’Crowley, staff writer for the New Jersey *Star Ledger*, in her recent article, “Social Security Still Undervalues Career Women.”

“That’s because Social Security was created in the 1930s for families headed by a male breadwinner and an at-home wife,” she writes. Under current law, a woman is eligible for half of her husband’s Social Security benefit while he is alive and his full

benefit after his death. “That formula is still in place—although most mothers today are working and/or divorced, or never married in the first place.”

“Under what’s called the dual entitlement rule,” O’Crowley explains, “married working women cannot claim 100 percent of their own benefits, plus the spousal benefit.... A long-term result is dual earners end up with a steeper loss of income upon the death of a spouse.

“To get an idea of how the system works,” she writes, “let’s take two married couples: one, a traditional breadwinner and homemaker; the other, two working people. Because men still tend to make more money than women, let’s say each husband will get a \$1,600 monthly Social Security benefit, and working wife B will receive \$1,000 a month in Social Security if all stop working at the full retirement age of 67.

“At retirement, husband A collects 100 percent of his breadwinner’s benefit, while his wife is entitled to \$800, or half of his. Husband B collects his benefit of \$1,600, while his wife can choose between her own benefit or 50 percent of her husband’s—whichever is greater. Of course, she chooses her \$1,000 benefit.” In this case, wife B’s time away from raising her children is worth \$200 a month in retirement benefits more than she would have if she had stayed home. In most cases, however, the breadwinner in single-earner couples generally receives a higher salary than the primary earner in dual-earning couples. Thus the non-working wife would receive an even greater spousal benefit.

“Upon the husbands’ deaths,” she continues, “the homemaker wife may now collect \$1,600 of her husband’s full benefit, losing her \$800 a month. The working wife may now collect \$1,600 of her husband’s benefit, losing her own benefits of \$1,000 a month. The loss of [the couple’s] income to the widow who worked is about 40 percent, compared to a 33 percent loss of income to the widow who did not.”

O’Crowley cites Melissa Favreault, an Urban Institute sociologist, who claims “The percentage of women with no or little work history who are collecting spousal benefits is declining. In 2001, among women 65 and older on Social Security, one-third fit that category. That included 13 percent of women whose husbands were still alive and 21 percent who were widows.”

On the other hand, over 60 percent of women participate in today’s workforce. Yet, after averaging in “zero earnings years” for time spent out of the workforce, many women still collect on their husband’s benefits, thereby relinquishing all contributions the women paid into the system. Personal accounts would reward these women proportionately for the time they have spent in the workforce.

Prof. Lawrence J. Kotlikoff confirms that the current system favors single-earner couples. His recent policy report for the National Center for Policy Analysis, “[Does It Pay Both Spouses to Work?](#)” concludes that “Social Security penalizes moderate-income families by claiming one out of every six or seven dollars the second-earner spouse receives. Thus virtually all of the Social Security payroll tax is a loss for the working spouse.” Kotlikoff is a board member of the Cato Institute’s Project on Social Security Choice.

For information on the benefits of personal accounts for women, see the following Cato Institute policy studies: “[Greater Financial Security for Women with Personal Retirement Accounts](#),” by Darcy Ann Olsen, and “[The Benefits of Social Security Privatization for Women](#),” by Ekaterina Shirley and Peter Spiegler.

Invest Social Security in Homeownership?

Michael L. Whalen, a successful entrepreneur, adds an interesting spin to the debate on personal accounts. While opponents claim recent the market is too risky for retirement funds, Whalen suggests that Social Security taxes could help secure wealth and homeownership for working Americans. Excerpts of his *Oregon Seaside Signal* commentary, “Social Security should start at home, not be left to politics,” follow:

“The folks supporting a partial private choice make a simple, compelling case. The current system spends all of your Social Security taxes, and the matching contribution by your employer, on current governmental programs, effectively in exchange for a promise to tax future workers enough to pay you back when you retire.

“To make matters worse...the average rate of return implied in current Social Security benefits is a crummy 1 percent, a rip-off. [Furthermore], those unlucky people who die early, disproportionately minorities, don’t get a return on their contributions and, under the current Social Security system, have nothing that they can privately decide to leave to their family as they can with other private assets. The current system is plain outdated, unfair, and desperately needs new thinking.

“[The opponents to partial private choice] scream that allowing individuals to privately control some of their Social Security is a ‘risky scheme’ subject to the gambling of the stock market; something the public is too dumb to do. They ignore the fact the public markets have historically performed well over time, ignore the overwhelming success of IRAs and 401(k) plans, and ignore that there are numerous very low risk investments, such as high grade bond funds, that will, without question, beat a piddly 1 percent return.

“But here is another progressive answer to the “scare em, risky scheme” crowd; let people, as one option, invest part of their Social Security in their own homes. For most folks, their home is their single biggest asset, the core of their retirement nest egg. Mortgage rates historically have run between 6 and 8 percent, a pretty solid rate of return that will doubly your money in little more than a decade. Homeowners could use the private choice portion of their Social Security to accelerate the repayment of their home mortgage.

“Home ownership is a critical social cornerstone of America. It strengthens families and gives folks a real stake in America. The obvious advantages of accelerating the percentage levels of homeownership, especially the rapidly improving rates among minority groups, cannot be seriously debated. Home ownership has proven to be an overwhelmingly safe and sound investment for hundreds of millions of Americans over the past seven decades since the birth of Social Security. Home valuations have consistently risen across the country over time and will in the future. This is no ‘risky scheme’; it is a 21st century modification to a trusted system that Americans can confidently embrace if alternative private investment choices are less attractive to them.

“Let’s strengthen Social Security and the country by letting people bring social security back home—safe from Washington’s political machinations.”

French Crisis Escalates

While the future of Social Security in the United States looks bleak, several other countries will soon have to corner the first painful steps of reform. France, determined to reject individual investment based pensions but forced to push pension reform, now faces major strikes unmatched since those famous in 1995. In the name of “solidarity between generations,” it will retain the government-run system in which retirees will receive full pensions from the taxes of those who work.

Charles Bremner of the London *Times* reports: “France is expected to come to a near-standstill tomorrow when public-sector workers strike in a show of force aimed at reversing the reform program of President Chirac’s center-right government. The striker’s main grievance is a plan by Jean-Pierre Raffarin, M. Chirac’s Prime Minister, to trim the privileges of [public-sector workers] to bring them into line with the retirement age of the three quarters of workers who are in France’s private sector. Put simply, state employees will have to work three years longer than at present to qualify for retirement. Failure to reform will mean the collapse of the French pension system by 2020, experts say.”

Bremner continues: “Polls show that about 70 percent agree that some form of reform is necessary. The government says that without reform, the pension system will be [\$55 billion] in the red by 2020. Mr. Raffarin said, ‘I am not worried because the French fully understand that this reform is necessary. We cannot unload our problem on future generations.’”

At present, the United States has an opportunity to avoid passing tax burdens on to the next generation without jeopardizing today’s retirees. A true “solidarity between generations” should be as painless as possible.

Publications

In his recent study, “[Accounting for Social Security and Its Reform](#),” Prof. Howell E. Jackson of Harvard Law School argues that “in addition to misrepresenting the magnitude of the Social Security system’s looming financial crisis, the current accounting system for Social Security distorts public debate over Social Security reform proposals and confuses the relationship between Social Security and the rest of the federal budget. Were the financial statements of the Social Security system restated under generally accepted principles of accrual accounting, both the public and the Nation’s leaders would have a clearer picture of the true state of the system’s finances. In addition, accrual accounting would make it much more likely that the country and its leaders would begin a responsible and intelligible debate over competing proposals to reform the Social Security system.”

John B. Shoven, senior fellow at the Hoover Institution, says in “[If the Trust Funds Are Real, the Surplus Numbers Are Wrong](#),” that the “wealth accumulated by the trust funds has financed additional government spending and lower personal and corporate income taxes rather than providing incremental wealth to aid future workers

and taxpayers.” He concludes, “Unified budget accounting and the tax and spending decisions that have been made relying on this accounting have significantly reduced national saving and increased the tax burden on workers twenty and more years from now.”

On May 9, John Sabelhaus of the Congressional Budget Office presented his new paper, [“For Whom the Bill Tolls: Distributing the Costs of Maintaining Social Security Solvency.”](#) at the American Enterprise Institute. In his paper, Sabelhaus determines how the costs of maintaining Social Security solvency would be allocated across and within generations. He considers various reform options: increasing normal retirement age in line with life expectancy, reducing new benefit awards, investing some of the trust fund in equities, and creating individual accounts. He concludes that alternative reform scenarios differ significantly in terms of who gains from them, thus making this problem a political one. The baby boomers have no incentive to change; late baby boomers have no incentive to participate, leaving post-1970s cohorts to watch out for their own future. This paper highlights the importance of every age group’s participation in the reform debate.

Upcoming Events and Announcements

- On Wednesday, May 21, former representative Tim Penny (D-Minn.), chairman of the National Advisory Council, and Leanne Abnor, president [For Our Grandchildren](#), will be keynote speakers at a [Great Plains Public Policy Institute](#) luncheon in Sioux Falls, South Dakota. Penny and Abnor served on the President’s Commission to Strengthen Social Security. They will discuss the urgent need for Social Security reform and the various options under consideration, including voluntary personal retirement accounts. Ron Williamson, president of GPPPI said, “We are pleased to have two speakers of this caliber speak on this important issue and it promises to be an informative presentation.” The luncheon will be held at the Holiday Inn City Center in Sioux Falls starting at 11:45 a.m. For tickets or information please call 605-334-9400.

- The Cato Institute invites you to a Capitol Hill Briefing, [Entitlement Spending Explosion: Implications for the Federal Budget, Taxpayers, and Young Americans](#), featuring Douglas Holtz-Eakin, director of the Congressional Budget Office; Jagadeesh Gokhale, visiting scholar at the American Institute for Enterprise; and Chris Edwards, director of the Cato Institute’s Fiscal Policy Studies. The briefing will be held June 6, 12:00–1:30 p.m., Rayburn House Office Building, B-338, Washington, D.C. Cato Hill Briefings and luncheons are free of charge. To register for this event, please call Krystal Brand at (202) 789-5229 or e-mail to kbrand@cato.org.

- [Social Security Choice.org](#) will meet in Philadelphia, Pennsylvania, for a Town Hall Meeting on Social Security Reform, Monday, May 27 at 7 PM. Rep. Pat Toomey (R-Pa.); Michael Tanner, director of the Cato Institute’s Project on Social Security Choice; and Maya MacGuineas, New America Foundation, will discuss problems with the current system and lay out the critical need to move to a funded system with personal retirement accounts. The Philadelphia event will be at the Valley Forge Hilton, 251 West Dekalb Pike, King of Prussia, and is the fourth meeting on the statewide Town Hall Tour on Social Security reform. The tour will cover eight cities throughout Pennsylvania and

will run through June. [Click here for information](#) on first meeting at Penn State on April 24.

Job Opening, Senior Social Security Analyst: The Cato Institute's [Project on Social Security Choice](#) is looking for a senior Social Security analyst. The successful applicant will have an advanced degree in economics or a related discipline or equivalent experience. The candidate should have detailed knowledge and understanding of the U.S. Social Security system, as well as the economic and actuarial issues associated with various proposals to reform the system. Excellent written and communication skills are a priority. Candidates should be committed to the principles of limited government and individual liberty, as well as to reforming Social Security through individual accounts. Submit résumé and writing samples to [Michael Tanner](#), director of Cato's Project on Social Security Choice.

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