



# Social Security Choice

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

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

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### **Scott Burns: Private Accounts Give Current Workers a Fair Shake**

Writing in the *Dallas Morning News*, Scott Burns (coauthor of *The Coming Generational Storm*) offers personal retirement accounts as a solution to Social Security's financial crisis and the inherent problems of the system's pay-as-you-go structure. Burns's column, "[How to Fix Social Security](#)," begins by highlighting the hefty retirement benefits that could have been accrued had Americans been able to invest their payroll taxes instead of contributing to Social Security. While noting that switching to a system of private accounts would be a big change, Burns makes the point that a big change is necessary due in part to an unsustainable trend of increasing payroll taxes. He observes that since Social Security's inception, "[t]he payroll tax has done nothing but grow." An excerpt of the article follows:

"From 1.5 percent on the first \$3,000 of income in 1950, [the payroll tax] has grown to 5.3 percent of the first \$87,900 of income in 2004. Add disability insurance and Medicare, and the total tax rate for employees is now 7.65 percent.

"And that's just the employees' portion. Employers take the same amount straight from our pay and send it to Uncle Sam. It's just not labeled that way.

"Worse, the tax will continue to grow. According to Social Security Online's answers to frequently asked questions, people who are now 25 will see their scheduled benefits cut 27 percent in 2042, when they are 63, if the financing of the system isn't improved. Current payroll tax 'contributions,' in other words, may do far less for future retirees than they have done for current and past retirees. That's not exactly fair, is it?

"So let's ask and answer two questions.

"First, how much money could you accumulate if payroll tax contributions were invested?

"Second, if the money is invested, how will benefits promised under the current system be fulfilled during a transition period?

“To get an approximation of the first question’s answer, I calculated how much you would have accumulated if only half of the payroll tax money that went toward retirement security were invested in a stock index, a bond index or a 60/40 pension fund-like index.

“Assuming that you always earned at the maximum income—\$37,800 in 1984 rising to \$87,000 in 2003—and that you invested your payroll tax portion regularly, you would have accumulated about \$199,000 in the Standard & Poor’s 500 index, \$175,700 in a 60/40 domestic stock/bond mix and \$132,700 in intermediate government bonds.

“It is important to realize that we are not taking any money from the disability fund or from Medicare. It’s also important to realize that this was a period of relatively high returns. Large common stocks returned 13 percent annually during the period, and intermediate bonds returned 8.9 percent. Future returns might not be so good.

“On the other hand, this is only the results of 20 years, not a 40- or 45-year career. Also, most workers would have paid in less. Only 7 percent of all workers earn more than the Social Security wage base.

“Then again, you could double the accumulation simply by investing the other half of the money.

“Caveats notwithstanding, real people could have accumulated a good deal of real money if they had invested the money for their own future. Instead, Social Security paid it to those who were already retired.

“With prospects for Social Security and corporate pensions getting worse by the moment, a private Social Security plan is starting to make real sense.

“Unfortunately, a private retirement plan for future retirees would leave current recipients of Social Security hungry. And there are 40 million of them.

“The only way to go private is to create an alternative source of support for the retired, a transition fund that would keep the promises already made. It would have to promise that no one would go hungry or suffer lower benefits.

“The solution that co-author Laurence J. Kotlikoff and I suggest in *The Coming Generational Storm: What You Need To Know About America’s Economic Future* (MIT Press, [www.mitpress.edu](http://www.mitpress.edu), \$27.95) is simple: a national sales tax. The tax would decline as promises were fulfilled and the liability was paid off.

“The tax would be applied to all consumer purchases, from food to bed sheets. People who don’t work would contribute through their spending.

“Rich people would support the elderly with their luxury purchases, including mega yachts. The rest of us would know that we were supporting retirees every time we filled our gas tanks or went to the movies. Only the elderly poor would be spared, because their Social Security benefits would be automatically adjusted as the sales tax inflated prices.

“There is no ideology behind this suggestion. We simply want a fair shake for young people and a retirement income system that works. The current system doesn't work in a world of rising life expectancies.”

Though a national sales tax is one suggestion for financing the transition to private retirement accounts, other options certainly exist, such as cutting corporate welfare. This transition cost is not an additional cost to taxpayers, and instead should be looked at as a savings in the trillions of dollars over the long run. For more information on transition financing, see [“Facts and Fantasies About Transition Costs”](#) by William Shipman, Cato Social Security Paper no. 13, October 13, 1998.

### ***Jerry Heaster: Social Security's Fatal Flaw***

Writing in last Sunday's edition of the [Kansas City Star](#) (registration required), columnist Jerry Heaster points to “the inevitable collision of soaring benefit growth and the declining ratio of workers to retirees” as the fatal flaw of Social Security. Discussing the recent analysis by Stephen J. Entin, president of the Institute for Research on the Economics of Taxation (IRET), Heaster argues the COLA is not the culprit, as some would suggest. Rather it is the initial benefit formula that would need serious adjustment to stay off disaster. An excerpt of Heaster's discussion follows:

“The COLA, [Entin] says, is justified because ‘it makes little sense to give people a certain initial benefit and then let it be whittled away by inflation.’

“What doesn't make sense, his research seems intended to show, is taxing low-income workers to pay some high-income retired couples what will become six-figure benefit packages toward the end of this century. This is why the basic benefit formula needs fixing, Entin said in a congressional advisory.

“The formula is designed to provide all beneficiaries with about the same benefits relative to pre-retirement income, which is known as the ‘constant replacement rate.’ Replacement rates are higher for those with low and average incomes, but payout amounts are greater for higher-income beneficiaries. What happens over this century, though, creates a widening spread between the haves and have-nots.

“By 2080 high-earner families with two workers eligible for full benefits will receive nearly \$107,000 in benefits. The lowest-earning couple would qualify for just under \$40,000 in benefits. This is in real dollars, based on inflation assumptions, Entin points out. Both payouts will be well over double the current benefit level.

“This growth in benefits will come as the number of workers supporting the system shrinks from the current level of 3.3 per beneficiary to 1.9 in 2080. This means, Entin says, the constant replacement rate must fall by just over 30 percent or the payroll tax must be increased by nearly 50 percent.

“Entin questions why a ‘social insurance safety net’ should push egregiously high taxes on 2080's low-income workers to pay Social Security egregiously generous benefits to an upper-income couple.

“None of these calculations, it’s worth noting, includes the payroll tax for Medicare, which faces bigger financial problems than Social Security. But that’s another column.

“Scrapping the COLA, as some have advocated, would not achieve more than a 5 percent savings, Entin estimates, which is dwarfed by a benefit growth projected to more than double. Besides, protecting beneficiaries from inflation is a good deal more morally defensible than taxing low-income workers into poverty to feather the nest of affluent retirees.

“Unfortunately, nobody’s idea of reform includes a more realistic or equitable benefit formula. Why? Most of those in a position to do something constructive now will be long gone when Social Security is in its death throes. And since the worst that can happen seems so distant, no current political leader wants to be the first to urge action.”

In the study Heaster refers to, Entin points out that reducing scheduled benefit growth is only a partial fix, one that “would make Social Security’s retirement system, already a bad financial investment compared to private saving, an even worse deal.... [T]he adverse effects could be offset by allowing people to put some of their Social Security tax ‘contribution’ aside to earn a higher return in a personal pension fund invested in private sector stocks and bonds. That arrangement would require the federal government to trim its own spending to pay for the diversion of the payroll tax.”

Entin’s paper (Congressional Advisory no. 169, March 24, 2004) is accessible on the [IRET Website](#).

## **Events**

The Cato Institute, along with a number of other organizations, will be participating in a policy forum entitled “Restoring Fiscal Sanity—While We Still Can.” Featured speakers at the event are Senators Joe Lieberman and John McCain. Cato Chairman William Niskanen will participate in a panel discussion on specific options for reform. The forum will take place on Tuesday, May 18, from 8:45 a.m.–11:30 a.m. at the Hyatt Regency Capital Hill. For more information, contact Diane Czastkiewicz at (202)986-6599.

## **Publications**

*Social Security and Its Discontents*, the new book from the Cato Project on Social Security Choice, is currently available from the [Cato online store](#). Edited by Michael Tanner, the volume includes chapters by Leanne Abdnor, Milton Friedman, Andrew Biggs, Jagadeesh Gokhale, Martin Feldstein, and José Piñera, among others. *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.

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