

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

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Arme y Warns of Social Security Crisis...

In dueling memos, House Majority Leader Dick Arme y (R-TX) and Rep. Robert Matsui (D-CA) have laid out what will likely be the two sides of the debate over Social Security privatization. In this first clash, at least, Arme y appears to have the upper hand.

In a [memo](#) to House Republicans, Arme y warns that Social Security faces an "unavoidable crisis" and makes several important points, among them:

* Social Security currently faces an unfunded liability of nearly \$22 trillion, an amount equal to:

- 3 times the current GDP
- 7 times the current national debt
- 11 times this year's federal budget
- 75 times the size of this year's defense budget
- 750 times the size of this year's education budget

* The Social Security Trust Fund "is merely an accounting device" that contains no real assets.

* Without individual accounts, the only way to fix Social Security is to raise taxes by 50 percent, drastically cut benefits, or deficit-spend on a massive scale.

* Social Security is becoming an increasingly bad deal for young workers. Arme y notes that a worker born in 1960 will receive a rate-of-return on his taxes of less than two percent. Workers born this year can actually expect a negative rate-of-return.

* Social Security is especially unfair to women, African-Americans and the poor.

Armev concludes that only personal accounts create sustainable solvency, increase real rates-of-return, create assets than can be passed on to one's heirs, and make it possible to reduce payroll taxes over time.

...And Matsui Responds

The anti-privatization response to Armev's memo came in the form of a memo from Representative Matsui to his fellow Democrats in which he denied that there was a Social Security crisis and maintained that Social Security was a "better deal than individual accounts."

Matsui claimed that the Bush administration is "attempting to manufacture a Social Security crisis" that does not exist. He attacks Armev's characterization of the Social Security Trust Fund as not being an asset (echoing Matsui's earlier attacks on Treasury secretary O'Neill over the same subject.) Matsui is clearly wrong on the facts here. As President Clinton's 2000 budget made clear "[Trust Fund] balances are available to finance future benefits...but only in a bookkeeping sense.... The existence of large Trust Fund balances, therefore, does not, by itself, have any impact on the Government's ability to pay benefits."

Matsui also makes the bizarre claim that creating individual accounts would reduce the rate-of-return on Social Security contributions to *below* the level of the current program. This analysis suffers from two flaws. First, it ignores the fact that the current program is unsustainable. Comparing a system of individual accounts to the current level of benefits is to compare it to a fantasy. Second, while some--but by no means all--methods of financing the transition might reduce the rates-of-return to private accounts, those returns would still be far in excess of those available under Social Security. (See, for example, ["Social Security is Still a Hopelessly Bad Deal for Young Workers,"](#) by Peter Ferrara, Cato Social Security Paper no. 18, November 29, 1999.)

Finally, Matsui claimed "privatization presents a particular danger to members of minority groups." He bases this claim on the increased use of survivors and disability benefits by African-Americans. However, he ignores the impact of shorter life expectancies, longer working lives, and lower savings rates on minorities. The evidence is clear that African-Americans receive an extremely bad deal from Social Security. (See, for example, ["Disparate Impact: Social](#)

[Security and African-Americans](#), by Michael Tanner, Cato Briefing Paper no. 61, February 5, 2001.)

It should also be noted that Representative Matsui does not offer any proposals of his own for fixing Social Security's problems. Since he rejects individual accounts, he must support tax increases, benefit cuts, deficit spending, or government investing. Unfortunately, he does not say which of those options he favors.

Munnell Pushes Government Investing

While some critics of Social Security privatization continue to simply deny the need for reform, the more thoughtful among them are increasingly falling back on the idea of allowing the government to directly invest Social Security surpluses. Advocates of this course claim it would allow Social Security to benefit from the higher returns of private capital investment without fundamentally altering the structure of Social Security. But advocates of government investment ignore significant problems with their proposal.

The latest effort to promote government investment is [an op-ed article in the Washington Post](#) by Alicia Munnell and R. Kent Weaver. Munnell is the director of the Center for Retirement Research at Boston College and a prominent advisor to both the Clinton administration and the Gore presidential campaign. Weaver is a senior fellow at the Brookings Institution. They propose that the Social Security Trust Fund be allowed to invest in "corporate equities and bonds in the same way that private pension funds, public employee pension funds and the Canada Pension Plan (the Canadian equivalent of Social Security) do." Doing so, they argue, "offers the advantage of individual accounts without the risks and costs."

However, allowing the federal government to directly invest in private capital markets poses serious risks of its own. Government investment decisions almost inevitable become politicized. Munnell and Weaver dismiss this fear saying that state and local pension funds, the federal Thrift Savings Program (TSP), and the Canada Pension Plan have not had their investment decisions politicized. This seems a preposterous assertion, especially regarding state and local pension funds. Fully 44 percent of all state, county and municipal pension programs have targeted investment requirements (such as investment in housing, renewable energy, or in-state industries), mandated by state legislatures for entirely political reasons. In addition, 25 percent of such funds have investment restrictions on investments (i.e. no tobacco stocks). For details on the politicization of public pension investing, see ["The Perils of Government](#)

[Investing.](#)" by Michael Tanner (Cato Institute Briefing Paper no. 43, December 1, 1998).

Moreover, the Thrift Savings Plan is not a good analogy because it is a defined contribution plan, giving ownership rights to the investors, and creating a fiduciary duty on the part of fund managers. In contrast, under defined contribution programs such as Social Security, workers have no property rights, are merely one "stakeholder" among many. In such cases, fund managers are free to balance the interests of various stakeholders, including "society at large," meaning politically directed investments are acceptable.

Finally, as noted two weeks ago, a [World Bank study](#) has shown that the Canada Pension Plan's management has indeed become politicized, and the fund has actually lost money (adjusted for income growth). Indeed, the World Bank concluded that nearly all government investment funds lost money, compared to privately managed funds, which nearly all earned positive returns.

Munnell and Weaver are also mistaken on another point. Government investment does not provide *all* "the advantages of individual accounts." Government investment, unlike individual accounts, would do nothing to raise the rate-of-return received by young workers. Any increase in returns under government investment would be realized by the system itself. Young workers would still receive below market returns, and inadequate retirement benefits. Government investment would do nothing to fix the inequities within Social Security that penalize African-Americans, workingwomen, and the poor. Government investment would not help low-income workers accumulate real wealth, and would not make Social Security benefits inheritable. And finally, government investment would not give workers ownership or control over their retirement funds. Workers would still be exposed to the political risk of depending on the political process to determine their retirement income.

401(k) Declines No Reason to Worry About Privatization

A new study has found that 401(k) plans lost value for the first time last year, and opponents of privatization immediately seized on the report to warn against the dangers of private investment. In reality, however, private capital markets remain far safer in the long run than Social Security.

According to the report, which received [front-page coverage from the New York Times](#) and other papers, the value of assets in an average 401(k) declined from \$46,740 in 1999 to \$41,919 in 2000. Although precise data was not

available, it was likely that account values declined an additional \$600 during the first half of 2001.

While opponents of privatization were quick to draw analogies to proposals for individual accounts, there is far less here than they would like to pretend. First, the decline in 401(k) values over the past year merely reflects the cyclical ups and downs of the market. But investment for retirement is not about short-term market fluctuations, but long-term trends. In that regard, it is important to recognize that even after the recent decline in 401(k) values, holders of those accounts are far better off than if they hadn't invested at all. Indeed, recent declines simply brought the value of accounts back to the level they were in 1998.

While it will always be possible to pick a limited time period during which markets decline, there has never been a 20 year period in U.S. history during which individuals would have lost money in the market. Young workers with 401(k)'s, and workers given individual accounts under Social Security privatization, will be investing for 40 years or more. They can be confident that over that period of time, returns will approximate the annual historic average of between 7 and 8 percent.

Social Security Subcommittee To Hold Hearings on Foreign Social Security Reform

The Social Security Subcommittee of the House Ways and Means Committee will hold a hearing on Social Security reform in other countries on July 31. Among those testifying will be Jacobo Rodriguez, assistant director of Cato's Project on Global Economic Liberty. Rodriguez is the author of "[Chile's Private Pension System at 18: Its Current State and Future Challenges](#)" (Cato Social Security Paper no. 17, July 30, 1999) and "[In Praise and Criticism of Mexico's Pension Reform](#)" (Cato Policy Analysis no. 340, April 14, 1999).

While the United States struggles with how to reform its Social Security system, other countries around the world are rapidly moving to systems that include individually owned, privately invested accounts. Many have fully privatized their public retirement systems. Witnesses at this hearing are expected to look at the experiences of such countries as Chile, Great Britain, Australia, and Sweden.

Mitch Daniels: Lock Box a Silly Idea

An epidemic of truth telling seems to have broken out among Bush administration officials. A few weeks ago, it was Treasury Secretary Paul O'Neill

telling us that the Social Security Trust Fund has no assets. Now, according to [*New York Times* columnist Paul Krugman](#) (who supports the lockbox), OMB director Mitch Daniels has revealed that proposals for Social Security lock boxes are a sham. According to Krugman, Daniels explained, "There is no box. There is no mattress. Paul O'Neill doesn't have a hole in the backyard where this money goes...what's unfair is to mislead the American people into thinking this money's in a box somewhere. It isn't. That box has nothing but promissory notes in it."

Daniels is entirely correct. Social Security is a pay-as-you-go system, meaning each year's benefits must be paid out of revenues collected in that year. Between now and 2015, the Social Security system is expected to run a surplus. The surplus revenues are used to purchase government bonds, which are credited to the Social Security Trust Fund. Those bonds are a promise against future tax revenues payable in whatever year they are redeemed. The Treasury having "sold" the bonds to the Trust Fund, receives in turn the revenue from that sale, which becomes general government revenue. Traditionally that extra revenue has been simply spent like all other government revenue. Under lock box proposals it could only be used to pay down the national debt. But it would still be spent for that purpose. It would be gone. It would not be "saved" for Social Security. The exact same bonds would remain in the Social Security Trust Fund no matter what the government spends the money on: paying down debt, tax cuts, or new spending programs.

As far as Social Security is concerned it doesn't change a thing. Come 2016, the program will begin running a deficit. In order to pay promised benefits, the government would have to find revenues with which to redeem the bonds in the Trust Fund. They won't find those funds in a lock box.

Cato Forum to Examine Commission's Interim Report

The President's Commission to Strengthen Social Security is expected to release its interim report on July 24. The next day, July 25, the Cato Institute will host a forum to examine that report. Professor Thomas Saving of Texas A&M, a member of the President's commission will present the commission's findings, to be followed by comments and reactions from a panel of experts representing a variety of viewpoints on Social Security reform. Among those invited to participate are Roger Hickey of the Campaign for America's Future, Robert Bixby of the Concord Coalition, and former House Speaker Newt Gingrich. The forum will be held at noon in Cato's F.A. Hayek auditorium.

