C A T O P R O J E C T O N

Social Security Choice

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

WEEK OF AUGUST 20, 2004

Washington Post: PRAs Could Increase Savings, Help with Long-Term Deficits

Without specifically endorsing individual accounts, the *Washington Post* ran an editorial last Sunday discussing the merits of and drawbacks to reforming Social Security via private retirement accounts. Citing estimates from supporters of PRAs, the *Post* wrote that private accounts could generate economic growth, increase savings, and reduce the immense projected future costs of Social Security. An excerpt of the editorial follows:

"Mr. Bush's sympathizers are right that Social Security privatization could reduce long-term deficits and right that the nation should not be deterred by the transition costs. On a long-term view, high transition costs might be worth paying, even though 'transition' in this instance would last for four decades or so.

"Under most versions of privatization, the government would forgo some revenue from payroll taxes, which would instead be diverted into private savings accounts. These accounts would be allowed to hold equities, which would generate an investment return; this would unlock a new source of money to finance Social Security. If bundled together with modest benefit cuts, privatization could contain the projected growth in Social Security costs.

"Privatization could also stimulate economic growth, boosting tax revenues and so strengthening the nation's fiscal prospects via a second route. By converting the payroll tax into contributions to personal accounts, government could reduce the tax burden on workers, thereby boosting incentives. Moreover, private accounts would boost national savings, which might drive down interest rates and stimulate extra corporate investment and growth. This might or might not happen in the short term, depending on whether private accounts foster a savings culture—a plausible outcome, but not a sure bet. In the long run, however, privatization is a way of shifting the nation from a pay-go system to a pre-funded one. Savings would become more plentiful.

"How much this could shrink the future deficit depends on the details of the reform plan. But make an assumption that's generous to the privatizers: Suppose that reform could cut in half the expected increase in the cost of the program. Between now and 2040, the cost of paying retirees is projected to rise from 4.3 percent of GDP to 6.5 percent; halving that rise would reduce the deficit in 2040 by just over 1 percent of GDP. Is that a big deal? The Berkeley-Brookings projections put the size of the deficit in 2040 at 20 percent of GDP, so containing Social Security costs might address one-twentieth of the problem.

"What about the growth effects? Nobody really knows how much extra labor or savings there would be, let alone how far extra savings would boost corporate investment, which is how savings help growth. But consider, again for the sake of argument, the high-end estimates from Harvard University's Martin S. Feldstein, the leading academic proponent of privatization. Mr. Feldstein believes that the boost to the labor supply could eventually increase GDP by 1 percent, and that the savings boost could add a further 4 percent."

Martin Feldstein Breaks Down Kerry's Social Security "Plan"

Economist Martin Feldstein, writing in the *Wall Street Journal*, analyzes both the Bush and Kerry approaches to Social Security reform. He looks at plans that President Bush has proposed since the early days of his administration and at the statements on Social Security that Sen. Kerry has made on his website and in campaign speeches. After outlining the Bush position, Feldstein builds on Kerry's statements to offer a breakdown of new taxes and benefit cuts that would be necessary under Kerry's plan. An excerpt of the article appears below:

"Although John Kerry has not laid out a plan to reform Social Security or to solve its fiscal problems, he has given some indication of how he might cut Social Security benefits. In a speech in Ohio and on the Kerry-Edwards Web site, Mr. Kerry has said that he would consider 'making sure that high-income beneficiaries don't get more out than they pay in' as taxes during their working years. In practice, the Kerry plan would mean cutting Social Security benefits by about 80% for those whose benefits are reduced.

"Here's why: The Social Security payroll tax is paid on income up to a limit—currently $87,900—that rises annually with overall wage growth. Individuals and employers now each pay a 5.3% tax for Social Security retirement benefits, with a maximum individual tax payment in 2004 of $4,659. Additional payroll taxes are paid for Medicare and disability insurance.

"Anyone who turns 65 this year and who has always paid the maximum Social Security tax would have paid total taxes from age 21 to 65 of $82,066. Such a new retiree would now be entitled to annual benefits of about $22,000, an amount that would rise with the price level. With an expected remaining life of 17 years and a 2% inflation rate, this retiree would receive $440,000 by age 82. To limit the expected benefit to the $82,066 paid in lifetime taxes, the Kerry plan would require cutting the benefit by 80%. The annual benefit would fall from $22,000 to only $4,100.

"Mr. Kerry has not said which 'high income' retirees would be hit by these drastic cuts. If it is limited to the same top 3% of income earners as the $200,000-plus group that Mr. Kerry has targeted for an income tax increase, the number of individuals and the cut in total Social Security outlays would be very small. Even the 80% cut in benefits for that group would reduce total Social Security outlays by less than 5%. A benefit cut targeted in that way would be more of a gesture against high earners than a serious attempt to reduce Social Security's fiscal shortfall.

"It would, moreover, be unfair to cut the benefits by 80% for someone who earns $200,000 and not to cut the benefits of someone who makes only slightly less. What logic could there be to cutting the benefits of those who had preretirement incomes over $200,000 to $4,100 a year while still paying benefits of $22,000 a year to someone with a pre-retirement income of $190,000? Moreover, if increasing preretirement earnings from $190,000 to $200,000 a year caused an individual to lose nearly $18,000 a year in retirement benefits, there would be a strong incentive to work less or to receive more potential income in the form of untaxed fringe benefits. The Kerry benefit cut therefore could not be just for those with very high incomes but would have to be phased out gradually at lower incomes.

"Mr. Kerry should explain how far down the income distribution he would apply his proposed benefit cut. There are two clues to his thinking on the Kerry-Edwards Web site. We are told there that Mr. Kerry will not 'cut benefits for people that rely on Social Security.' Since more than a third of the labor force participate in 401k plans with more than $1.5 trillion in assets and tens of millions have IRAs with more than $2.5 trillion in assets, Mr. Kerry could cut benefits for a large number of middle-class individuals who do not 'rely on Social Security.'

"The Kerry Web site also emphasizes that 'current law revenues would be sufficient to pay 73% of scheduled benefits after trust fund exhaustion in 2042.' So is Mr. Kerry willing to accept an expected benefit cut of 27% for all future retirees?

"If that's the plan, it would be good for younger workers to know. And those who may be in line for drastic cuts in the near term would also welcome some clarification from Mr. Kerry."

Barone: Bush Will Need to Court Young Voters with Social Security

In an appearance last week on FoxNews' "Special Report with Brit Hume," commentator Michael Barone argued that in order to win this November, President Bush will have to cater his message on Social Security to younger voters, a group with whom the president has had minimal success in various polls. An excerpt of the interview follows:

> ***Barone****:* [The Bush campaign is] already rolling out the ads with his second term programs, which he hadn't said much about until now. One of those interestingly is the individual investment accounts and Social Security. And I think that that has a potential of winning him some votes.

If you look at the Pew poll that came out recently, it showed Bush-Cheney...

Hume: Yes, just out.

Barone: ... just out today 45 for Bush-Cheney, 47 percent for John Edwards. The A.P.-Ipsos poll came out 48-45 for John Kerry, almost identical results. But when you look at that Pew poll and you look at the age groups, stratification by age, what you find is that the young voters, the under 30 or 35, are 53-35 Kerry. Bush has been doing poorly with young voters in just about all the polls across the board. They also are the ones with the least information of the different age groups and perhaps the more likely to switch.

Bush strategists believe that an eventual investment accounts in Social Security will win them votes among young voters. Kerry said he wants no change in the Social Security system. Bush wants to give them this option. Polling tends to suggest that that will be the case, at least when people are given that abstract question. We'll see what happens in the actual campaign.

Hume: What about the ads? Bush has had this new ad out that have him speaking in the ads. Mrs. Bush at his side in at least one of them. What is your judgment about their effect?

Barone: Well, he's—those ads, or at least one of them, is rolling out the theme of the ownership society, that you'll own your retirement, that you'll [own your] healthcare. And this is part of what he wants to present as a serious policy agenda for a second term.

Abdnor and Penny: Addressing Social Security Can't Wait

Leanne Abdnor and Tim Penny, writing in the *Washington Times*, point out that because of the "pay-as-you-go" nature of Social Security, the system will begin to run a deficit by the year 2018. It is in 2018—not 2042 or 2052—that the serious fiscal problems will begin, they write. In 2018 the federal government will have to begin cashing in the IOUs in the Trust Fund to pay benefits, which will wreak havoc on the budget. And raising taxes, they caution, won't do the trick. The full text of their comments follows:

"Last month, another report was released on Social Security's inability to pay future benefits, this one from the Congressional Budget Office. Unfortunately, this report will only serve to confuse and mislead the public further. The headlines read, 'Report: Social Security may stretch to 2052.' Opponents of reform with personal retirement accounts heralded this as a reason not to act soon. But, here is the rest of the story:

"Social Security is—and always has been—a pay-as-you-go system in which current workers pay the taxes that fund benefit checks for current retirees. For the past 20 years, due to tax increases imposed in 1983, the Social Security system has been collecting more taxes each year than are needed to pay benefits. But the money has not been saved. Instead, it has been spent on other federal government purposes. In reality, the Social Security Trust Fund contains no cash, just government bonds. These bonds amount to IOUs that will some day need to be repaid.

"Beginning in 2018, Social Security payroll taxes will no longer provide enough revenue to pay promised benefits to existing retirees. At that point, the Social Security Administration will begin cashing in those bonds. But where will the money come from to pay off the bonds? Unless Congress decides to reduce Social Security benefits (an unlikely option), legislators will then have only two other options. They can begin cutting other government programs or they can increase income or payroll taxes.

"Let's assume Congress decides to cut government programs to cover the Social Security shortfall. How much would have to be cut? The numbers are mindboggling. To give you an idea of the magnitude of the problem, here are some examples of possible program cuts.

"According to the Social Security Trustees, in the first year of Social Security's cash deficit—2018—the shortfall is relatively small, estimated at only $16 billion. Using the present cost of government programs, we'd have enough money to make up this shortfall if we eliminated the Environmental Protection Agency, Head Start and the Food and Drug Administration.

"By the following year, 2019, the shortfall more than doubles. So, added to the first round of cuts, we'd have enough to pay Social Security benefits if Congress also eliminated the Women, Infants and Children nutrition program, the Centers for Disease Control and Prevention, all federal student loans, all federal food-safety inspections and the Small Business Administration.

"In the third year, Congress could make up the additional deficit by eliminating the Department of the Interior, including money for the Fish and Wildlife Service, the National Parks and the Bureau of Indian Affairs.

"Within three more years, additional cuts comparable in size to the food stamp program and Supplemental Security Income would be required. And it gets worse every year. By now, you get the picture.

"So, don't be lulled into complacency by political rhetoric about Social Security's trust fund lasting until 2042 or 2052. It is a false promise, at best. Every reputable government agency—from the General Accounting Office to the Social Security actuaries to the Congressional Budget Office—agree on this basic fact: Starting in a few years, Congress will have to decide whether to cut existing programs or raise your taxes in order to pay off the trust fund bonds.

"Given the obvious difficulty of enacting the deep cuts we have just described, few political observers believe that Congress will cut other programs to make up the shortfall. That leaves tax increases as the only remaining option—which is why some elected officials want you to think the problem is far away in 'never never land.' The sooner Congress acts, the more options will be put on the table. But, if Congress waits, younger workers had better get ready to open up their wallets."

BAMPAC President: Social Security Is Unfair to African-Americans

In an opinion piece appearing in the *Milwaukee Journal Sentinel*, Alvin Williams, president and CEO of Black America's Political Action Committee, argues in favor of private accounts to alleviate the injustices that make the current Social Security system unfair to African-Americans. Given that African-American males, in particular, have a much shorter life expectancy than other demographic groups, Williams writes, many don't live long enough to recoup their Social Security "contributions," nor do their families inherit any wealth. The full text of the article follows:

"After the passage of the Civil Rights Act of 1964, the Voting Rights Act of 1965 and the Fair Housing Act of 1968, most Americans believed the federal government had removed all of the legal barriers that prevented African-Americans from participating fully in the political and economic life of our country.

"Now, 40 years later, we are starting to see things differently. Indeed, we now realize that one of the greatest barriers to the full integration of African-Americans into the economic mainstream of America is a creation of government itself.

"We're not talking about some pernicious Jim Crow law intended to hold black people back. Rather, we're talking about one of the alleged bedrocks of the U.S. social safety net: the Social Security system.

"As strange as that may seem, the Social Security system, which observes its 69th birthday today, has done little to help African-Americans. In fact, it has probably had the opposite effect—helping to keep poor people poor and helping to close the door to higher education, the surest way out of the low-income ghetto.

"To realize why it has had this effect, you must understand how the Social Security system works and acknowledge a few facts about longevity among African-Americans.

"The latter is easy to explain because it's simple: longevity is comparatively rare in the African-American community. Indeed, according to a recent U.S. Administration on Aging fact sheet, African-American life expectancy is just over 70 years, compared to an average of 76.5 for the population in general.

"'The difference in life expectancy is even more striking among African-American men, who have a life expectancy of only 66.1 years, compared to the national average of 73.6 years for all men,' the fact sheet noted.

"What this will mean to the average African-American working man who retires several years from now at age 66 is that he'll receive one or two Social Security checks and take them to his grave. So every dollar they 'contribute' to Social Security will go to somebody else.

"That's because of the way the Social Security system is structured. Unlike an individual retirement account (IRA) or 401(K) retirement plan, when money is deducted from your paycheck for Social Security it goes into the federal Treasury. What was yours yesterday is the government's today.

"All you have is a promise: In exchange for your Social Security taxes, the government promises to provide you with a monthly stipend—starting in your mid-to late 60s—to help finance your retirement.

"But there's an important catch: to collect this stipend, you have to live long enough.

"Unfortunately, many African-American men don't. Some don't live long enough to collect anything. Others don't live long enough to recover what they've paid into the system over the years, with or without interest. So the money is lost—to them, to their children and grandchildren and to the community at large.

"If the money had been set aside in private retirement accounts, the owners of those accounts could bequeath it to their children or grandchildren, to help them start small businesses, pay off the mortgage or pay college tuition. Similarly, some of the money could be left to charity: to finance scholarships, for example.

"But Social Security doesn't work that way. When you die, your Social Security benefits generally die with you.

"That's why we are now finding consistent support among African-Americans for changing the Social Security system to give people the 'option' to invest some of their Social Security taxes.

"Updating Social Security by adding a private pension option would give workers ownership of the money they pay into that part of the program, promote long-term wealth accumulation and give low-income citizens the same opportunity to help the next generation that has long existed among the wealthy.

"For many African-Americans, Social Security is a stacked deck. They can only come out losers. It's time to change that."

For more information on African-Americans and Social Security, see Michael Tanner's "Disparate Impact: Social Security and African Americans," Cato Briefing Paper No. 61, February 5, 2001.

Social Security Expected To Be Part of Bush Campaign Agenda

A pair of commentaries about the Bush campaign's sweeping second-term economic plans appeared this week, one in the *Washington Times* and the other in the *Wall Street Journal*. Both pieces look at Social Security as a part of President Bush's larger economic plans for a second term. Excerpts of each piece follow.

Writing in the *Wall Street Journal*, Alan Murray suggests that Social Security reform is a key part of Bush's ownership society theme, which has been a tough sell thus far. But there are encouraging signs, he adds. Murray writes: "The president's call last week for a new era of ownership needs work from the marketing mavens. ('We want more people owning things in this country' isn't much of a rallying cry.) Still, it strikes me as a step in the right direction. The U.S. triumphed in the great struggle of the 20th century because it demonstrated a market-oriented economy with limited government could do more for the 'masses' than either communism or the mixed and managed economies of Europe and Asia. For the U.S. to triumph in the great struggle of the 21st century, it needs to prove the point again. And the movement toward a kind of mass capitalism hinted at by President Bush last week could help do that.

"The big economic-policy challenge facing the next president isn't how to boost job growth—that will happen in time—or how to boost wages—they will inevitably rise with productivity. The big challenge is how to survive the retirement of the baby boomers, which begins in just five years, without dramatically altering the nature of American society. Left untouched, Social Security and Medicare could cause the U.S. government to swell to 30% or more of the economy from 20%. The welfare state that the U.S. held at bay through the final quarter of the 20th century would expand with a fury. And make no mistake about it: Social Security and Medicare, as now constituted, are a form of welfare.

"President Bush's ownership agenda offers the beginnings of a different direction. Social Security could be transformed, at least in part, from a welfare program to a savings plan—providing all Americans a nest egg that they could own and either use in retirement or pass on to their heirs. The nation's health-care system, which has been insulated from the benefits of the marketplace by a third-party payment system that leaves employers and the government picking up the bill, would be turned into a real marketplace, with consumers owning their own health-insurance plans, making their own decisions about how to spend their health-care dollars, and reaping the benefits of any savings.

"Can President Bush sell the American public on such a bold agenda? It won't be easy. With the economy weak and stocks in the doldrums, Americans have lost their enthusiasm for the wonders of the marketplace. Four years ago, more than 40% of voters considered themselves members of the 'investor class'—a sign that a mentality of mass capitalism was already taking hold. Today, says Mr. Zogby, that is down to just 29%."

David Lambro of the *Washington Times* notes: "[T]he boldest, most sweeping economic growth proposal in Mr. Bush's re-election agenda is clearly his Social Security reform plan to let workers build investment wealth they would own, control and could pass on to their children.

"Mr. Bush ran on partly privatizing Social Security in 2000, an idea particularly popular with younger workers and championed by Mr. Rove in White House strategy meetings. But the idea was also shoved aside after the September 11, 2001, attacks.

"Now Bush is renewing his call to enact Social Security investment accounts in a second term, even making it part of his campaign stump speech. The prospect of dramatically reforming the venerable New Deal program has noticeably energized his conservative base.

"'Bush opened the door for Social Security reform in the 2000 election,' said Jack Kemp, chief architect of the Reagan tax cuts. 'He has continued to champion reform throughout his first term, and now he's made Social Security a predominant part of his re-election agenda.'

"Will all of this move Mr. Bush's polling numbers upward? That remains to be seen, say Republican strategists.

"'I still think the election won't be a referendum on what he will do in the next four years, but a referendum of the policies he has already put in place,' said Stephen Moore, president of the pro-tax cut Club for Growth.

"But Mr. Moore also thinks Mr. Bush needs to convey some big ideas about his plans for a second term. 'He needs to talk about Social Security reform and moving toward a simpler, flatter tax system, because he'll need some kind of mandate to do these things. And if he doesn't talk about it, it won't happen,' Mr. Moore said."

60 Plus Association: U.S. Should Follow the Example of Countries with PRAs

Jim Martin, president of the 60 Plus Association, and Hugh C. Newton, an adviser at 60 Plus, make the case in the *Washington Times* for privatized Social Security accounts by pointing out the successful programs of other nations. In particular, Martin and Newton praise the efforts of Great Britain, which allows for roughly one-third of the payroll tax to be placed into private accounts. The full text of their editorial follows below:

"How can we save Social Security for everyone's benefit in this country? They know the answer in Great Britain. They know the answer in Australia. And in Mexico. And in many countries in Latin America, starting with Chile more than 20 years ago. As the respected Heritage Foundation notes, some 39 countries have adopted pension reform that includes personal retirement accounts (PRAs). Even Russia is considering some form of PRAs for its workers.

"Yet, we in this country diddle around, with many people unwilling to face our serious problem. Today is the 69th anniversary of Franklin Roosevelt's signing of the original Social Security Act. By 2037, Social Security will be completely broke. The solution of liberal Democrats, who vehemently oppose PRAs, is higher taxes and lower benefits.

"As Jack Kemp said recently: 'Mr. Kerry has avoided addressing Social Security. He is under enormous pressure from the left wing of the party to sign onto the ill-conceived idea of abolishing the payroll tax and converting Social Security and Medicare into monumental welfare programs.

"So let's take a look at what has happened in Great Britain. In the 80s, Great Britain let people opt out of their state system. Its success at reforming its government pension system has gone practically unnoticed in America even though the British experience contains many lessons for U.S. politicians.

“Here’s how the British system works. In addition to a basic government-run pension, there is a second layer of benefits where British workers have a choice: They can take those benefits from the government, or they can take a tax cut equal to 4.6 percent of their annual earnings—almost one-third of the basic payroll tax—and invest it in a private pension.

“The private options include either a company pension plan or a personal pension plan similar to individual retirement accounts available in the United States.

“The result: Most British workers no longer have to worry whether they’ll have enough money to retire. Private British pensions have grown to more than $1 trillion—which approaches the size of the entire British economy and exceeds the pension funds of all other European nations combined.

“British lawmakers handled the politics of Social Security reform smartly, taking early steps to ensure the changes would be good for everyone. By law, the investment companies that manage private pensions must provide workers retirement incomes at least as large as they would have received under the government system. In practice, private pension plans deliver incomes more than 2 times higher. Another plus: British lawmakers made ‘opting out’ voluntary—any worker who wants to remain in the government system can do so.

“As so many nations around the world have shown, the answer to our growing Social Security problem is to transform the system into a real prefunded personal investment system—just like all federal employees and members of Congress have.

“At 60 Plus, we believe everyone should have the opportunity to accumulate wealth in his own account and be free to leave a legacy for his family. A personal retirement account (PRA) would provide this opportunity and help close the wealth gap in a single generation. Thirty-nine countries around the world have so far reformed their systems and given their citizens a choice, thus providing more secure retirements for all. We believe Americans deserve nothing less, especially for our grandchildren.

“With lower birthrates dictating fewer workers paying in and with lifespans well past 65, clearly the wave of the future are the reforms instituted by more than three dozen countries.

“It’s time the United States moved briskly into the 21st century on saving Social Security for future generations.”

Federal Reserve Board Governor: Transition Costs Shouldn’t Prohibit PRAs

As reported by *Reuters*, Federal Reserve Board Governor Edward Gramlich suggests that Social Security reform plans such as PRAs that have large transition costs should not be eliminated from consideration. Instead, Gramlich calls for the transition costs to be paid from internal financing, not from general revenues from the federal budget. In concluding, Gramlich points out Social Security’s obligation to disabled workers, and warns against promoting plans that ignore this part of the Social Security program's costs. An excerpt of the article appears below:

"Any plans to reform the Social Security retirement program should be self-financed and not rely on general government revenues, Federal Reserve Board Governor Edward Gramlich said on Thursday.

"Gramlich said when the U.S. government was facing budget surpluses a few years ago, some reform proponents supported plans that would have drawn on general budget revenues to put the program on sound long-term footing.

"'Let's stop the practice and require all plans to be internally financed,' Gramlich said in remarks prepared for delivery to a retirement research conference.

"'Now that we have budget deficits as far as the eye can see and deficits that are large and getting larger, my case for fiscal abstinence should be much stronger,' he said.

"Gramlich, who chaired a Social Security advisory council that came up with reform recommendations in 1997, said a self-financing requirement need not stand in the way of plans with large transition costs, such as proposals to convert to a system with individual private retirement accounts.

"'This stricture would not abolish plans with transition costs—it would require only that any taxes or benefit cuts needed to fund the transition be explicitly identified and assessed,' Gramlich said.

"President George W. Bush has called for private accounts, but has given the issue little attention in the current presidential campaign.

"Some Republicans are concerned large up-front costs could derail Social Security as a Bush campaign issue, but a campaign spokesman has denied that is the case.

"Gramlich said plans that allow equity investments should not immediately assume stocks will outperform bonds.

"'Claiming higher returns on system or individual portfolios invested in equities is legitimate only if the simulation also factors in the greater investment risk,' he said."

Upcoming Events

Cato analyst Jagadeesh Gokhale will testify before a hearing of the Senate Special Committee on Aging entitled "Mandatory Retirement Age Rules: Is it Time to Re-Evaluate?" The hearing will take place Tuesday, September 14th at 10:00a.m. in Room 628 of the Dirksen Senate Office Building.

Freedom Works, the result of the recent merger between Citizens for a Sound Economy (CSE) and Jack Kemp's Empower America, and the Republican Liberty Caucus are currently on a Social Security tour, leading townhall meetings about options for reform. Florida Freedom Works state director John Hallman will speak at a meeting of the Republican Club of Central Palm Beach County meeting at 6 p.m. on Wednesday, Sept. 1, at the Atlantis Country Club, 190 Atlantis Blvd., near Lantana. For more information, look here.

Edited by Brooke Oberwetter, boberwetter@cato.org. To subscribe or unsubscribe to *Social Security This Week*, please contact Feliz Ventura at (202) 789-5202 or fventura@cato.org.