



# Social Security Choice

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

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

WEEK OF SEPTEMBER 10, 2004

### ***Holman W. Jenkins: Now Is the Time to Tackle Entitlements***

Writing this week in the *Wall Street Journal*, commentator Holman W. Jenkins Jr. argues that President Bush's apparent willingness to tackle entitlement reform—specifically by privatizing Social Security as a first step—creates a rare and historic opportunity that is “not to be passed up by a society that cares about its future.” Jenkins presents several steps that will need to be taken to sell private accounts to the American people, but concludes that now is the best—and possibly only—time for meaningful reform of the system to take place. His commentary follows.

“Now that a Social Security overhaul has been put on the national agenda by President Bush and his campaign advisers, advocates need to get busy helping the public master a peculiarity of federal accounting. To wit, promises made to bondholders show up in the national debt. Promises made to future retirees don't.

“Thus the officially recognized national debt is about \$3.9 trillion, while the unfunded Social Security obligation alone represents an IOU of \$10 trillion in present value. Throw Medicare onto the bonfire and that's another \$62 trillion.

“Keep in mind these figures represent only the ‘unfunded’ portion, not the part covered by monies already credited to notional federal trust funds or to be collected in payroll taxes from now till eternity. It would take \$3.9 trillion today to retire the visible national debt, and \$72 trillion today to pay off unfunded promises to retirees. Yet only the first debt is reported to voters. That's the kind of accounting ‘oversight’ that, in the private sector, leads straight to a cellblock.

“So let's recruit Joe Lieberman for Job One, propagandizing on behalf of realistic budgeting. He recently introduced a Senate bill to impose just such ‘present value’ accounting on the federal government. No doubt he would receive enthusiastic support from the Medicare and Social Security trustees, who produced the above estimates. Why is this important? Because suddenly the \$1 trillion in ‘transition costs’ to finance the creation of the Bush-touted private retirement accounts for younger workers doesn't seem so outlandish compared to the real federal debt, visible and invisible.

“Next up is Job Two, spreading an understanding that such transition borrowing would, in fact, be ‘refinancing.’ In effect, Treasury bonds due in 30 years would be sold to investors and the money used to retire Social Security obligations to younger workers, also due in roughly 30 years. The younger workers could reinvest the money in productive assets, for the benefit of themselves and the economy as a whole.

“Here, we should call on Suze Orman, Jane Bryant Quinn and the folks at Kiplinger’s, accomplished expositors of financial thinking for the general public. It doesn’t hurt, too, that many leading opinion makers have just been through the educational experience of refinancing their Nantucket manses.

“Job Three: Plenty of work remains for Pete Peterson, the Concord Coalition and other longtime Jeremiahs of the federal budget. The Bushies mean well but there’s no doubt that Republican lawmakers will shrink from a deal that asks anything of anybody. Remember, the goal is not just to supplement Social Security but to substitute real ownership of real assets for the current federal Ponzi scheme. That means younger workers should be expected to give up some of their future entitlement in return for the right to invest a portion of their payroll taxes today.

“Job Four is a toughie. Unreasoning risk aversion is a hallmark of the human mind, and Democrats and their pet economists are already doing all they can to encourage the stand-pattism of certain voting blocs, especially single women and oldsters. John Kerry never tires of frightening these voters with the Satans of Wall Street and Ken Lay. He says instead a ‘tweak here, tweak there’ will tide Social Security over without any ‘risky’ reforms.

“But those tweaks we already know about, thanks to Brookings economist Peter Orszag and MIT’s Peter Diamond, who’ve laid out a mix of higher payroll taxes, delayed retirement eligibility, and reduced benefits for ‘wealthy’ retirees. (Their program might even be a plausible cure if the much bigger problem of Medicare didn’t also exist, for which Social Security reform is a necessary dry run.)

“Here we must summon the heavy guns of ‘behavioral economics,’ whose adherents have been winning Nobel Prizes lately. Their most firmly established insight is that real people, as opposed to the rational maximizers of the economic texts, suffer from an excess of caution. ‘Prospect theory,’ pioneered by Daniel Kahneman and Amos Tversky, shows that people overvalue their fear of loss and undervalue the prospect of gain, leaving themselves worse off than they would be if they were willing to entertain reasonable risks.

“But another finding by Messrs. Kahneman and Tversky would actually boost the political appeal of reform: People become inordinate risktakers to protect something they have. Once voters figure out the true extent of the entitlement morass, even those summering Nantucket editors might be expected to rush to the barricades and, whatever their cultural affinity, cast their vote for Mr. Bush for the simple reason that entitlement reform is inescapably a second-term activity.

“Even Bill Clinton was close to endorsing private accounts before Hurricane Monica disrupted his second term. President John Kerry would be sure to lay back too

while re-election sugarplums still danced in his head, and who'd want to bet on him to beat the Democratic curse and win a second term? If not, nine years would be the soonest reform could start, by which time another \$18 trillion in unfunded retirement obligations would have piled up.

“Nope, it’s Mr. Bush or bust. Congress is no help. Wonder why, in the dog days of August, GOP House Speaker Denny Hastert became a sudden convert to a flat tax? He was hoping to divert the Bush White House’s attention from Social Security reform. His members, facing re-election every two years, still believe that Social Security is an untouchable ‘third rail,’ notwithstanding a few GOP thrillseekers who’ve lately done handsprings on the third rail and lived to tell the tale.

“Democrats, of course, can be expected to resist ferociously, and for reasons going beyond mere sentimental attachment to the FDR/LBJ welfare state. Anything that turns the adult population into wealth holders would change voting behavior forever, and not to Terry McAuliffe’s advantage.

“All this makes Mr. Bush’s apparent willingness to tackle entitlements a once-in-a-generation planetary alignment, not to be passed up by a society that cares about its future.”

### ***Rich Lowry: Kerry Likely to Attempt Demagoguery on Social Security***

Writing this week on [National Review Online](#), Rich Lowry predicts that Democratic presidential nominee John Kerry will have no choice but to stoop to demagoguery on Social Security: the widespread support for private accounts as the most viable option for reforming the ailing system will essentially force Kerry, who has continually asserted his opposition to privatization, to resort to an emotional appeal. Lowry’s commentary follows.

“‘He wants to take away your Social Security.’ John Kerry hasn’t uttered these words about President Bush yet—but he will as his campaign inevitably sinks to the lowest common denominator of Democratic demagoguery.

“Bush has made himself more vulnerable to the charge than the average Republican by endorsing Social Security reform in his acceptance speech at the GOP convention. Bush thus demonstrated his willingness to confront the Democratic equivalent of the Brezhnev Doctrine when it comes to entitlements—once established, entitlements never recede, but only grow larger. Bush dares to imagine something other than a 70-year-old New Deal model for dealing with retirement. If he can create a mandate for something new, his second term could be as consequential domestically as his first term was abroad.

“The current Social Security system is on its way to becoming the WorldCom of entitlements. The Social Security Trustees estimate the program will begin running a deficit in 2018. The red ink will amount to \$16 billion that year and will climb every subsequent year. Cato Institute analyst Michael Tanner estimates the program’s shortfall from 2018 going forward at \$26 trillion. Washington, we have a problem.

Within the constraints of the status quo, there are only two solutions: cut benefits (which Kerry, of course, rules out) or hike taxes (which everyone rules out, right up until the point the taxes are hiked).

“On top of this looming bankruptcy, Social Security is becoming an ever-worse deal for workers. In 1950, there were 16 workers per beneficiary. Now there are three. The rate of return for workers is steadily dwindling. According to the conservative Heritage Foundation, a married family with one earner born in 1932 and two children gets 4.74 percent back on its retirement taxes. The same family with the earner born in 1976 gets less than 2.6 percent, and the return gets smaller for younger families. Even very conservative investments in bonds and stocks would yield returns substantially higher.

“Most reform plans would leave the current system for older workers, but give younger workers a choice: Stay in Social Security as it exists now, or opt to keep some amount of their payroll tax to invest and save in personal retirement accounts, in exchange for reduced benefits from Uncle Sam. The transition to this new system in the near term would be financed either by debt or (preferably) spending restraint. But the government wouldn’t be incurring any new expenses in the long run, since it is already obligated to pay for the retirement of current workers (young people opting out of the system, in effect, take their retirement benefits early through their reduced payroll taxes).

“Liberals have screamed in recent years that Bush has only cut income taxes and not the regressive payroll tax (which funds Social Security and Medicare), but now that Bush supports an idea that amounts to a payroll-tax cut, liberals will attempt to demagogue it into extinction.

“Too bad. Roughly 75 percent of Americans pay more in Social Security taxes than in income taxes, according to the Heritage Foundation. From 2 percent 50 years ago (split between employer and employee), the tax has jumped to 12.4 percent now. In 1971, it applied to only the first \$7,800 of income; now it applies to the first \$84,900. This burden squeezes the ability of people, especially low-income people, to save.

“Personal retirement accounts will give people an asset that they themselves own and that government can’t take from them. Depending on how the transition is financed, they might well boost national savings, something economists consider key to an economy’ health. They will deliver a rate of return to retirees higher than that of Social Security. And they will create a citizenry less dependent on government entitlements and more self-reliant, in the finest American tradition.

“To all this, a John Kerry fearful of change and wedded to the status quo will have essentially one response: ‘He wants to take away your Social Security.’”

### ***Jagadeesh Gokhale: True “Cost” of Reform Is Mischaracterized***

In a commentary released this week, Cato snior fellow Jagadeesh Gokhale takes issue with various politicians and commentators who imply that President Bush’s Social

Security plan would involve a huge cost of \$2 trillion. Gokhale first points out that President Bush hasn't actually endorsed a specific reform plan, which makes claims about the plan's cost somewhat suspect at best. But assuming that critics are referring to Plan II of the President's Commission on Social Security, Gokhale continues, it is still difficult to see an additional cost of \$2 trillion; shifting to a system of private accounts would make hidden costs seen, Gokhale argues, but it wouldn't create costs that don't already exist. An excerpt of Gokhale's commentary follows.

“Neither the most recent Economic Report of the President nor the President's Social Security Commission's report confirm a \$2 trillion ‘transition cost.’ However, for the sake of argument, we'll assume that the \$2 trillion refers to the present discounted value of additional *explicit* annual deficits over the next 75 years that would arise from implementing Plan II. But, as explained below, these are not ‘new’ deficits.

“Along with guaranteeing the benefits of current retirees and those close to retirement, Plan II would also reduce the growth of benefits for future retirees. This would be accomplished by modifying the formula applied to workers' past earnings for calculating benefits.

“Reducing the growth' in benefits is not the same thing as ‘reducing benefits.’ So, future retirees who choose to remain under the current Social Security system can expect to be just as well off as today's retirees under this plan.

“Those who participate in Plan II's individual accounts are likely to be better off: Their account balances would face somewhat greater market risk, but they would be subject to a much smaller risk of arbitrary future tax and benefit changes by Congress—a risk that is substantial today and growing.

“Under the current system, future tax/benefit changes could take the form of increases in the retirement age, subjecting benefits to additional income taxation, higher payroll taxation or higher income taxation to finance needed general revenue transfers toward Social Security. And such changes are surely inevitable if we retain the current system's financing structure.

“Under Plan II, those who chose personal accounts could tailor their retirement finances to suit their needs—by exerting greater choice in purchasing guaranteed annuities or retaining their assets and leaving them to their children. These benefits of reform are rarely, if ever, included in cost estimates.

“But here's the main point: The so-called ‘costs’ of reform are already there. They're part of the current system and will continue to grow unless reforms take them fully into account. The full, official measure of the government's commitment to pay future retirement benefits in excess of future payroll taxes amounts to \$12 trillion under the current system. And, just like debt, this cost grows with interest as time passes. Those who say Social Security doesn't need reform need to specify where that \$12 trillion is going to come from.

“Under the current system of budget accounting, all of this cost remains hidden. Indeed, because the Social Security trust fund currently holds government IOUs, many

believe that Social Security is well funded and not in trouble; and this partly explains the eye-widening reaction when someone suggests that the ‘transition cost’ of a reform plan is \$2 trillion.

“Few people appreciate that the amount of those Trust Fund IOUs is insufficient to pay more than 3 years’ benefits to current retirees. The remaining years’ benefits must come out of current payroll taxes paid by workers—which implies those funds won’t be invested for their own future retirements.

“Hence, transforming the system by introducing personal accounts won’t create ‘new’ costs. It will only make existing costs visible. But Plan II also *reduces* the system’s overall costs by slowing future benefit growth.

“In effect, the \$2 trillion estimate (if correct) reflects the amount of the existing system’s shortfall that remains after the full impact of Plan II’s is accounted for. Indeed, because this estimate is based on an accounting of Plan II’s impact only over the next 75 years, it surely *understates* the true size of the cost savings that would be implemented were we to adopt Plan II.

“Finally, anyone suggesting that the reform plan will ‘cost’ \$2 trillion has the story exactly reversed. The correct interpretation is that Plan II goes a long way toward dealing with the current system’s resource shortfall—it addresses about \$10 trillion of the existing system’s \$12 trillion shortfall.

“At the same time, Plan II will probably improve the economy’s efficiency because workers will view their contributions to individual accounts as their own savings rather than as a tax. Indeed, Plan II represents a huge improvement over the ‘do nothing’ option which leaves a \$12 trillion wide river of red ink untouched.”

### ***Heritage’s David C. John: The Trust Fund Debate Is Misleading***

In a Heritage Foundation [Executive Memorandum](#), Social Security analyst David C. John writes that in the debate over Social Security reform, politicians who suggest that the fiscal problems facing the system can be fixed by focusing on the “trust fund” are misleading the public as to where the true problems lie. The “trust fund,” John writes, is merely an accounting entry, which doesn’t represent cash or even real assets that can be used to pay benefits. Rather than focusing attention on the trust fund, politicians should be focusing on ways to create a better return on Social Security contributions, John concludes. The text of the memorandum follows.

“As political leaders debate how best to fix Social Security, many policymakers are focusing on the wrong issue. Their sole concern seems to be the date when the Social Security retirement and survivors trust fund will run out of its paper assets. This mistaken emphasis misses the fundamental point about Social Security’s problems: There is no cash in the Social Security trust fund, and there never has been any.

“The Social Security trust fund is merely an accounting device filled with IOUs that future taxpayers must repay. Far too soon, payroll taxes will be insufficient to pay

all of the promised benefits. Unless Congress promptly takes action, taxpayers will have to pump hundreds of billions of additional tax dollars into Social Security to pay the promised benefits.

### *How the Trust Fund Operates*

“Workers pay their Social Security taxes through their employers. Each employer periodically sends a lump sum payment to the U.S. Treasury that includes all of the income taxes and Social Security and Medicare payroll taxes paid by both the employer and its employees.

“The Treasury both receives the payroll taxes (and income taxes that higher-income retirees pay on their Social Security benefits) and pays monthly benefits on behalf of the Social Security Administration (SSA). The money stays in the Treasury's hands until it is either paid out as Social Security benefits or otherwise spent by the government. In fact, no money ever goes into the trust fund. Instead, the trust fund balance is the result of two accounting entries by the Treasury.

“First, the Treasury estimates how much of the aggregate tax receipts are Social Security taxes and ‘credits’ the Social Security trust fund with that amount. Then the Treasury ‘subtracts’ the total amount paid in monthly Social Security benefits from the trust fund balance. No money actually changes hands; these are strictly accounting entries.

“Any ‘money’ remaining in the trust fund is converted into special-issue Treasury bonds, which are really nothing more than IOUs. In addition, the Treasury pays interest on the trust fund's balance by crediting the trust fund with additional IOUs. These are also strictly accounting entries, and again no money changes hands. After crediting the trust fund with the proper amount in IOUs, the government spends the extra Social Security tax collections just like any other tax revenue—to finance anything from aircraft carriers to education research.

“At the end of 2002, the Social Security trust fund had a balance of \$1.22 trillion. During 2003, the Treasury received \$544 billion in Social Security taxes and paid out \$406 billion in Social Security benefits. Therefore, the trust fund received \$138 billion in these special-issue Treasury bonds, resulting in a trust fund balance of \$1.36 trillion at the end of 2003.

### *Why the Social Security Trust Fund Differs from Real Trust Funds*

“Private-sector trust funds invest in real assets ranging from stocks and bonds to mortgages and other financial instruments. However, the Social Security trust funds are only ‘invested’ in a special type of Treasury bond that can only be issued to and redeemed by the Social Security Administration. As the Congressional Research Service noted in a report on May 5, 1998:

When the government issues a bond to one of its own accounts, it hasn't purchased anything or established a claim against another entity or

person. It is simply creating a form of IOU from one of its accounts to another.

“According to the Office of Management and Budget under the Clinton Administration in 1999:

These [trust fund] balances are available to finance future benefit payments and other trust fund expenditures—but only in a bookkeeping sense. These funds are not set up to be pension funds, like the funds of private pension plans. They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury, that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures.

“In short, the Social Security trust fund is really only an accounting mechanism. The trust fund shows how much the government has borrowed from Social Security, but it does not provide any way to finance future benefits. The money to repay the IOUs will have to come from taxes that are being used today to pay for other government programs. For that reason, the most important date for Social Security is 2018, when taxpayers must begin to repay the IOUs, not 2042, when the trust fund is exhausted.

### *Conclusion*

“Social Security’s financial crisis will begin far sooner than many politicians claim. In less than three years, the first baby boomer will reach retirement age. Once that happens, Social Security (and Medicare) will be on a slippery slope toward insolvency. While Social Security can continue to use its tax receipts to pay full retirement benefits until 2018, Congress cannot wait that long to act. Misleading the public into believing that Social Security is secure until 2042 or beyond will only make the impending crisis more difficult to avoid.

“Furthermore, huge impending deficits are only one of the problems facing Social Security. The sad reality is that millions of workers receive a dismal rate of return on their Social Security retirement taxes. Making matters worse, the current program does not enable workers to build up investments and cash savings to supplement their monthly Social Security checks.

“The debate about Social Security’s future should be about how to improve each American’s personal retirement security and how to enable each American to build a nest egg for the future. Otherwise, Americans will lose a real opportunity to improve the lives of future retirees. The best way to fix Social Security is to provide younger workers with the opportunity to invest part of their Social Security taxes in personal retirement accounts.”

## **Concord Coalition: Both Parties Must Face Up to Reform Challenges**

In a press release late last week, the Concord Coalition released a statement calling on both parties to “reject ‘free lunch’ and ‘do nothing’ plans [for Social Security] by facing up to the real trade-offs that must be made to reform the system in a way that is fiscally sustainable and generationally equitable over the long-term.” Robert Bixby, executive director of the Concord Coalition, while pointing out the many advantages to private accounts, cautioned that the switch to such a system will necessitate upfront costs that will need to be accompanied by better fiscal discipline and increased national saving. Bixby said the following:

“The Social Security debate has gone off-track. Leaders of both parties are in denial. Too many Democrats minimize the enormous challenges facing the current system by arguing that the program’s trust funds are ‘solvent’ for about 40 years. Too many Republicans assume that these challenges can be met by simply creating personally owned retirement accounts. It’s time to set aside comforting slogans and confront the fundamental fact that Social Security promises more in future benefits than it can deliver under current law. Over the next seventy-five years, the program’s projected annual cash deficits total a staggering \$26 trillion in today’s dollars. That is why any responsible reform plan, with or without personal accounts, must start with cost-saving measures that close Social Security’s long-term cash deficit.

“Personal accounts have many potential advantages, including higher returns on worker contributions and a more reliable method of prefunding benefit promises than government trust funds. But the money to fund the accounts must come from somewhere. Funding more of Social Security’s benefits is not a way to avoid the hard choices. It is *the* hard choice. Diverting existing FICA taxes to fund personal accounts would increase the already ballooning federal deficit and decrease national savings. Without *new* savings, a reform plan will not increase the productivity of tomorrow’s workers, and thus becomes a zero-sum game of pushing liabilities from one pocket to another or from one generation to another.

“The fact that the Social Security trust funds are projected to be solvent until 2042 does not provide an excuse to delay reform. The trust funds represent nothing more than a promise from one arm of government (Treasury) to pay off IOUs held by another arm of government (Social Security). To make good on this promise, Congress will have to raise taxes, cut other spending, or borrow more from the public. The key issue is not trust fund balance but how much paying off the IOUs in the trust fund is going to cost future taxpayers and whether it is affordable.”

## **Publications**

The White House released a new fact sheet last week entitled “[President Bush’s Commitment to Strengthening Social Security](#).” The fact sheet outlines the problems facing Social Security and identifies private accounts as the president’s preferred solution while establishing several other key principles for reform. According to the fact sheet,

“Establishing personal accounts does not add to the total costs that Social Security faces. The obligation to pay Social Security benefits is already there. While personal accounts affect the timing of these costs, they do not add to the total amount obligated through Social Security. In fact, every plan scored by SSA that contains personal accounts would, according to actuarial analysis, reduce the costs of *permanently* fixing the system.”

The fact sheet concludes by suggesting that providing meaningful leadership on the issue of Social Security will require acknowledging that the upfront costs of reform would not be additional costs, but are instead costs that already exist.

The Information Office of China’s State Council has issued a new white paper titled “China’s Social Security and Its Policy.” The paper highlights the need for reform of the old system—which was closely linked to China’s socialist planned economy—given the gradual change to a market economy and the rapid aging of the population. The full text, which includes information on China’s old age insurance, health insurance, disability insurance, and general social welfare, can be seen [here](#).

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