Social Security privatization
CATO INSTITUTE

SOCIAL SECURITY THIS WEEK

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Cato Scholar to Testify at October 18 Commission Meeting

Michael Tanner, director of the Cato Institute's Project on Social Security Privatization will be among those testifying before the President's Commission to Strengthen Social Security at its next meeting, October 18, at the Park Hyatt Hotel, in Washington, DC.

Tanner expects to set out a series of principles that he believes should guide any proposal for Social Security reform. These include:

> ***Solvency Is Not Enough:*** Workers deserve the best possible deal for their dollar. With Social Security facing a financial crisis—it will begin running a deficit in just 15 years—much attention has been focused on ways to keep the program solvent. Theoretically, that could be accomplished by raising taxes or cutting benefits. But Social Security faces a second crisis as well: Young workers will receive a negative rate of return from the

program. They will get less back in benefits than they pay in taxes. That low return, and other inequities, is particularly disadvantageous to women, the poor, and minorities. Any Social Security reform must reverse this trend, raising the rate of return and providing higher retirement benefits. Finally, any Social Security reform must give workers ownership and control over their retirement funds.

Individuals, Not Government, Should Invest**:** The only way to increase Social Security's rate of return is to invest Social Security taxes in real capital assets. This should be done through the creation of individually owned accounts, not by allowing government to directly invest payroll taxes. Individual accounts would give workers ownership of and control over their retirement funds, allowing them to accumulate wealth and pass that wealth onto their heirs; it would also give them a greater stake in the American economic system. Government investment would allow the federal government to become the largest shareholder in every American company, posing the potential threat to corporate governance and the specter of social investing.

Maximize Consumer Choice: Workers should be given as wide a range of investment opportunities as possible, consistent with regulatory safeguards against fraud or

speculation. While investing in “Singapore derivatives” is clearly not envisioned, there is no reason to limit workers to only two or three index funds. As much as possible, the existing retirement savings infrastructure should be used, meaning workers would have a large number of safe and secure options. Moreover, a safety net would guarantee that no senior would end up in poverty as a result of bad investments.

Don’t Touch Grandma’s Check: Benefits to currently retired and nearly retired should not be reduced. Indeed, by explicitly recognizing benefits owed to current retirees, privatization would guarantee those benefits in a way that the current political system does not. Making the transition to a new system while guaranteeing current benefits means that the government will have to issue debt, cut current spending, or sell assets, but those “transition costs” will be substantially less than the costs of maintaining the current system.

More Privatization Is Better Than Less: You don’t cut out half a cancer. Given the advantages of a privatized Social Security system, there is no excuse for stopping at the privatization of only 2-3 percent of payroll taxes. Once Congress has conceded that private capital investment can provide better and more secure retirement

benefits, it should press on allow workers to control the maximum feasible amount of their retirement income.

Rumor Control: Moynihan Not Leaving

The hot rumor in Washington last week was that former Senator Daniel Patrick Moynihan was resigning as co-chairman of the President's Committee to Strengthen Social Security, supposedly unhappy over the commission's refusal to postpone its report until spring. The report sparked a flurry of press inquiries and speculation. However, sources close to the commission quickly reported that there was no truth to the story--Moynihan remains co-chairman and expects to complete the commission's work. In fact, it now appears that the rumor was being spread by the offices of some congressmen opposed to privatization.

From Canada: A Cautionary Tale on Government Investing

The recent experience of the Canadian Pension Plan (CPP) offers a cautionary example of what can happen when the government mandates investment decisions. The CPP Investment Board was mandated by law to invest at least 35 percent of its assets in a portfolio that tracks the Toronto Stock Exchange 300 composite index. When Nortel shares rose higher than $120 last summer, it came to dominate the TSE 300 -- and the CPP board's portfolio. By

August 2000, 28% of the board's assets were in Nortel stock. When the stock's price began to collapse this year, the board was unable to protect itself by selling. Forced by government fiat to hold a falling asset, the CPP lost $852 million.

Much of the opposition to government investing has focused on the potential for government intervention in business decisions and the political manipulation of investments. The experience of federal, state, and municipal provide clear evidence of these dangers. Fully 44 percent of such funds operate under investment mandates, such as requirements that they invest in in-state industries, affordable housing, or renewable energy. An additional 25 percent face investment restrictions, such as prohibitions on investing in tobacco stocks or companies doing business in certain countries. In addition, state pension funds have occasionally used their voting power to interfere in corporate governing decisions. (See, Michael Tanner, "The Perils of Government Investing," Cato Institute Briefing Paper no. 43, December 1, 1998.)

However, as the CPP experience shows, government investing often simply lacks the flexibility to react to rapidly changing markets. The simple lesson should be—bureaucrats make poor investors.

Military Personnel Now Eligible for TSP

Beginning this week, 2.5 million members of America's armed forces will be able to participate in the Federal Thrift Savings Plan (TSP) on the same basis as Federal civil service and postal employees. The additions will bring to roughly 5 million the number of workers participating in the defined contribution retirement program often mentioned as a model for a privatized Social Security system. Workers are able to invest in one of five different private investment funds, ranging from bond funds to stock funds. The success of the TSP shows that is possible to administer millions of small individual investment accounts and that workers without a great deal of experience are able to make their own investment decisions.

In August, Roger Mehle, executive director of the Federal Retirement Thrift Investment Board, which manages the TSP, testified before the President's Commission to Strengthen Social Security and pointed out that, workers have earned returns ranging from 6.7 percent for the bond fund to 17.4 percent for the stock fund.

Mehle also testified that the TSP has extremely low administrative costs. Expenses for managing the TSP range from 5 basis points (five one-hundredth of a percent of assets managed) for the bond fund to 7 basis points for the stock fund.

Record Number of Americans Own Mutual Funds

Approximately 54.8 million American households owned mutual funds of May 2001, according to a new report from the Investment Companies Institute (ICI), up from 51.7 million a year earlier. This represents approximately 42 percent of American households, a record number. On an individual basis, 93.3 million Americans owned mutual funds, meaning that roughly one out of every three Americans now owns a fund. In addition, the ICI reports that 44.3 million American households own Individual Retirement Accounts (IRAs). This represents roughly 42 percent of American households, also a record number.

These numbers provide solid evidence that critics of privatization are wrong when they claim that average Americans are incapable of making investment decisions. They also show that t is administratably feasible to manage a large number of individual accounts.

However, the report also shows that mutual fund ownership is still deeply divided along income lines. Only 21 percent of households with income below $25,000 per year owned mutual funds, while 85 percent of households with income above $100,000 owned such funds. Advocates of privatization have long argued that allowing workers to invest a portion of their payroll taxes would open up wealth accumulation and investment options to low-wage workers. The ICI report provides new evidence why that is important.

Social Security Privatization: Now More Than Ever

Writing in the *Detroit News* on Sunday, October 7, Michael Tanner, director of Cato's Project on Social Security Privatization, made the case that Social security reform remains an important issue, even in the aftermath of the September 11 terrorist attacks. Tanner wrote:

> In a sign that Washington is slowly returning to normalcy, the President's Commission to Strengthen Social Security will hold a public hearing later this month on the future of Social Security reform, its first since the terrorist attacks on the World Trade Center and the Pentagon.

Social Security reform? In the wake of September 11, it may seem hard to get excited about something as mundane as reforming Social Security.

Yet, the problems facing Social Security have not changed. Prior to September 11, Americans understood that the nation's retirement program was financially unsustainable, provided a poor and deteriorating rate-of-return for young workers, treated working women and minorities unfairly, and gave workers no ownership or control over their retirement income. All those things remain true after September 11.

In fact, it may be more important than ever to move aggressively on the issue. Social Security currently faces a future deficit of more than $22 trillion. Without massive tax hikes or benefit cuts, the federal government will have no choice but to shift enormous amounts of General Revenue into the program. As time goes on, more and more of the federal budget will be devoted to simply propping up Social Security. That means less money available for national defense, anti-terrorism efforts, or any other national priority.

Social Security privatization offers a way out of that conundrum without cutting benefits or piling more taxes on already burdened workers.

A second post-September 11 consideration for Social Security reform is the impact of reform on economic growth. Congress and the President are struggling for ways to stimulate the

economy in the attack's aftermath. While short-term stimulus is important, we should also be considering ways to strengthen the economy for the long run.

A shift to a private system, with hundreds of billions of dollars being invested in individual retirement accounts each year, would likely produce a large net increase in national savings, depending on how the government financed the transition. This would increase national investment, productivity, wages, jobs, and economic growth. Replacing the payroll tax with private retirement contributions would also improve economic growth, because the required contributions would be lower and those contributions would be seen as part of a worker's direct compensation, stimulating more employment and output.

Harvard economist Martin Feldstein estimates that privatization of Social Security would produce $10 trillion to $20 trillion in net present value benefits to America. Most of that would probably come in the form of the higher returns and benefits earned for retirees through private investment accounts. But some would come in the form of higher wages and employment for working people.

Of course some will use the stock market's dismal post-September 11 performance to suggest that privatization is too risky. However, even in this uncertain investment climate, several things should be remembered.

First, the market will eventually come back. U.S. financial markets have weathered catastrophic events before. Social Security privatization is not about short-term market fluctuations, but long-term investment. Historically, long-term investment has yielded average annual returns of nearly 8 percent. There is no reason to believe that that will not continue in the future. Those returns look awfully good next to Social Security's projected returns of barely 1.5 percent.

Indeed, it's worth remembering that a person retiring today would have begun investing roughly 45 years ago, when the Dow was at around 600. The market would have to fall a lot more than it has recently to wipe out all the gains that person would have made.

Of course, Social Security privatization does not mean investing only in stocks. Under most privatization scenarios, workers would be able to invest in a wide variety of instruments, including bonds, annuities, money market funds, and various products that provide a guaranteed return.

Finally, we should realize that the same economic fallout that is driving down the market also hurts the current Social Security system. Rising unemployment and declining tax revenue will worsen only Social Security's already severe financial problems.

Nothing that happened on September 11, or since, has made Social Security privatization less necessary. Certainly, for the

foreseeable future our number one priority must be the war against terrorism. But a great nation can walk and chew gum at the same time. Let's get on with the business of Social Security reform.

Upcoming Events

The American Enterprise Institute will host a forum on October 15 to address the question of "How Redistributive is Social Security?" Alan Gustman of Dartmouth College will be the featured presenter, with additional comments by Jeff Brown, of the President's Council of Economic Advisors, and Kevin Hassett of AEI.

The Cato Institute and the China Center for Economic Research will host a conference in Beijing, November 8, on "China's Pension System: Crisis and Challenge." Speakers include: Sun Jian Yong, Justin Yifu Lin, John Greenwood, Jose Pinera, William, Shipman, Michael Tanner, Mao Yushi, and Liu Ming Kang. To register, click here.

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