



Social Security Choice

SOCIAL SECURITY THIS WEEK

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

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Bush, Kerry Debate Social Security

In the third and final presidential debate, the candidates discussed their domestic agendas. Moderator Bob Schieffer asked the candidates about Social Security, the options for reform, and the financing of the costs.

After assuring current retirees and those nearing retirement that their benefits wouldn't be altered by reform, President Bush outlined his vision for a system of private accounts, stressing that action on reform to create stability and better returns for young workers would be a "vital issue" in his second term.

There is a problem for our youngsters, a real problem. And if we don't act today, the problem will be valued in the trillions. And so I think we need to think differently. We'll honor our commitment to our seniors. But for our children and our grandchildren, we need to have a different strategy.

And recognizing that, I called together a group of our fellow citizens to study the issue. It was a committee chaired by the late Senator Daniel Patrick Moynihan of New York, a Democrat. And they came up with a variety of ideas for people to look at.

I believe that younger workers ought to be allowed to take some of their own money and put it in a personal savings account, because I understand that they need to get better rates of return than the rates of return being given in the current Social Security trust.

And the compounding rate of interest effect will make it more likely that the Social Security system is solvent for our children and our grandchildren.

I will work with Republicans and Democrats. It'll be a vital issue in my second term. It is an issue that I am willing to take on, and so I'll bring Republicans and Democrats together.

And we're of course going to have to consider the costs. But I want to warn my fellow citizens: The cost of doing nothing, the cost of saying the current system is OK, far exceeds the costs of trying to make sure we save the system for our children.

Senator Kerry responded to the president's remarks, calling a system of private accounts "an invitation to disaster," though he offered no plan of his own other than suggesting that economic growth could solve the problems.

The CBO said very clearly that if you were to adopt the president's plan, there would be a \$2 trillion hole in Social Security, because today's workers pay in to the system for today's retirees. And the CBO said—that's the Congressional Budget Office; it's bipartisan—they said that there would have to be a cut in benefits of 25 percent to 40 percent.

Now, the president has never explained to America, ever, hasn't done it tonight, where does the transitional money, that \$2 trillion, come from?

He's already got \$3 trillion, according to The Washington Post, of expenses that he's put on the line from his convention and the promises of this campaign, none of which are paid for.

Not one of them are paid for....

We're going to protect Social Security. I will not privatize it. I will not cut the benefits. And we're going to be fiscally responsible. And we will take care of Social Security.

Referring to Kerry's comments in a later rebuttal, President Bush said, "I didn't hear any plan to fix Social Security. I heard more of the same."

Latest Nobel Prize Winning Economist Supports Private Accounts

Ed Prescott, currently the W. P. Carey Chair of Economics in the W. P. Carey School of Business at Arizona State University, became one of two winners of the 2004 Nobel Prize in economics this week. Though he won the award for his work on the driving forces behind business cycles, Prescott has also done work on the U.S. Social Security system, specifically arguing that reforming Social Security to a system of private accounts can improve work incentives, thereby boosting GDP, which would result in lessening transition costs. Based on incentives, Prescott believes that raising taxes to finance PAY-GO systems won't work. An excerpt from his 2004 paper "[Why Do Americans Work So Much More Than Europeans?](#)" follows.

"Americans, that is, residents of the United States, work much more than do Europeans. Using labor market statistics from the Organisation for Economic Co-operation and Development (OECD), I find that Americans on a per person aged 15–64 basis work in the market sector 50 percent more than do the French. This was not

always the case. In the early 1970s, Americans allocated less time to the market than did the French. The comparisons between Americans and Germans or Italians are the same. Why are there such large differences in labor supply across these countries? Why did the relative labor supplies change so much over time? In this article, I determine the importance of tax rates in accounting for these differences in labor supply for the major advanced industrial countries and find that tax rates alone account for most of them.

“This finding has important implications for policy, in particular, for financing public retirement programs, such as U.S. Social Security. On the pessimistic side, one implication is that increasing tax rates will not solve the problem of these underfunded plans, because increasing tax rates will not increase revenue. On the optimistic side, the system can be reformed in a way that makes the young better off while honoring promises to the old. This can be accomplished by modifying the tax system so that when an individual works more and produces more output, the individual gets to consume a larger fraction of the increased output.”

He continues: “I have estimated the elasticity of labor supply and have found it to be large, nearly 3 when the fraction of time allocated to the market is in the neighborhood of the current U.S. level. This estimate of the elasticity is essentially the same one needed to account for business cycle fluctuations. That this elasticity is large is good news. If labor supply were inelastic, the advanced industrial countries would face a cruel choice of either increasing taxes on the young, thereby lowering young people’s welfare, or not honoring the promises made to the old, making the old worse off.

“The large labor supply elasticity means that as populations age, promises of payments to the current and future old cannot be financed by increasing tax rates. These promises can be honored by reducing the effective marginal tax rate on labor and moving toward retirement systems with the property that benefits on margin increase proportionally to contributions. Requiring people to save for their retirement years is not a tax and does not reduce labor supply. My example establishes that reforms are possible that benefit the current young workers and future workers while honoring promises made to the old.

“One factor that I ignored in my social security reform example is that a larger capital/labor ratio increases wages with any reasonable aggregate production function. If this factor is taken into consideration, the welfare gains are larger. It is beyond the scope of this article to more than scratch the surface of how best to reform the social security retirement system and what the resulting welfare gains would be. But it is clear, given the high responsiveness of labor supply to marginal labor tax rates, that the potential gains are great.”

Gokhale and Smetters: Kerry’s Social Security Plan Won’t Work

Writing this week in the *Washington Times*, Cato senior fellow Jagadeesh Gokhale and Wharton School professor Kent Smetters argue that Kerry’s proposal to deal with the financial problems facing Social Security and Medicare by simply growing the economy simply doesn’t make sense; given that benefit levels are tied to wages (and wages are ostensibly tied to the health of the economy), relying on growth alone will not

only fail to solve the problems: it will make the problems worse. Their commentary follows.

“Sen. John Kerry is scheduled to speak at the AARP today, an organization that has focused most of its recent energy on Social Security and Medicare reform.

“President Bush’s and Mr. Kerry’s positions on those issues are well differentiated by now. While Mr. Kerry opposes creating personal accounts for Social Security, Mr. Bush favors giving workers more control over their retirement savings. Recent media reports, including in the Wall Street Journal (Sept. 2, 2004, ‘Ambitions to fix Social Security present big hurdles for Bush’), claim the Bush transition to personal accounts could cost up to \$2 trillion over the next 75 years.

“These so-called \$2 trillion in ‘transition costs’ are misleading because they simply represent payments already promised under Social Security—costs not properly tracked in the government’s current budget. While adoption of personal accounts would still require tough choices, personal accounts make explicit the costs of benefit promises implicit under current Social Security laws.

“The language of ‘transition costs’ diverts voters’ attention from the real cost they should examine: the cost of inaction.

“According to Social Security’s independent chief actuary, this program currently faces a present value imbalance of \$10.4 trillion. Without reform, this imbalance will grow by about \$322 billion next year. Including Medicare’s \$62 trillion present value financial imbalance, the two programs’ unfunded obligations will grow by a staggering \$2.2 trillion next year alone.

“That is why Mr. Kerry’s recent statements on Social Security and Medicare are so troubling. Besides opposing personal accounts, he promises to not reduce scheduled benefits—not even to control real benefit increases over time.

“Under current law, Social Security benefits grow with wages and, therefore, faster than inflation. That can only mean that if Mr. Kerry takes any initiative to reduce Social Security’s financial shortfall, it will favor tax increases.

“And for Medicare, Mr. Kerry wants to expand the new prescription drug benefit by eliminating the ‘donut hole’ in insurance coverage. Again, that can only point to a tax increase to solve Medicare’s financing problems. In contrast, Mr. Bush has offered at least a couple of suggestions for containing Medicare’s cost growth via Health Savings Accounts.

“Just how much would taxes have to increase if the growth in benefits in Social Security and Medicare were not contained? Using data produced by the independent actuaries at the Social Security and Medicare programs, we calculate payroll taxes would need to rise 17.4 percentage points—permanently. In other words, the current employer-plus-employee payroll tax rate of 15.3 percent would need to more than double.

“Our 17.4 percentage point estimate is, if anything, very conservative:

(1) The calculation assumes the permanent tax raise is done immediately. If the tax increase were delayed just four years until 2008, more than \$9.4 trillion in additional fiscal imbalances would have accumulated, requiring a tax increase of 19.7 percentage points.

(2) The 17.4 tax rate reflects the government's projection of growth rates in future health-care costs. Those projections are substantially lower than the actual cost growth since 1965 when Medicare was adopted.

3) This calculation assumes Mr. Kerry as president would not be able to expand the prescription drug subsidy—we simply assume he will not reduce Medicare benefits. Finally, we assume people keep working just as hard despite higher tax rates, thereby not shrinking the tax base.

“In several recent interviews, Mr. Kerry has also suggested the Social Security and Medicare problems could be avoided with a stronger economy. However, under current law, the wage-indexed Social Security benefits grow with the economy and Medicare outlays tend to grow even faster. Faster economic growth, therefore, is not the cure for these ills.

“More importantly, Mr. Kerry's prescription puts the cart before the horse. He makes economic growth the policy instrument and the Social Security and Medicare programs the policy objectives. These roles should be reversed.

“Social Security and Medicare reforms would expand domestic saving by reducing hidden liabilities and help fuel future economic growth. Conversely, failure to address these problems could lead to an anemic economy and lower living standards for future generations.”

Wall Street Journal: *Bush Plan Likely to Include Wage/Price Index Change*

David Wessel's weekly column in the *Wall Street Journal* this week looks at Social Security privatization. Noting that neither Bush nor Kerry have made strong declarations about how, precisely, they intend to reform the system, Wessel predicts what Bush's plan for reform would entail. Wessel specifically mentions the likelihood that a second Bush administration would change benefit calculations from being wage-indexed to price-indexed (which is a key part of the [Cato Institute's plan for reform](#)). Wessel's discussion of changing benefit calculations and the implementation of private accounts follows.

“A retiree's Social Security initial benefits depend on how much he or she earned over a lifetime of work. But \$1 earned in 1969 isn't worth \$1 in 2004. So Social Security uses a formula to adjust those old wages. It relies not on the familiar adjustment for price inflation but a more generous measure tied to the increase in economywide wages. Over time, wages increase faster than prices.

“Mr. Bush’s experts have discovered that if initial benefits were calculated by adjusting a workers’ lifetime wages only for rising prices, not for rising economywide wages, Social Security’s finances would be fixed. Look for something like that in any Bush plan. Mr. Bush’s campaign accurately says: ‘Today’s young workers...can expect to receive benefits with a value at least as high as those paid to today’s seniors, even after adjusting for inflation.’ It fails to add that their benefits would be a lot lower than preretirement paychecks than is the case with today’s retirees. Today’s 25-year-old average wage earner would retire with benefits about 28% lower than under current rules.

“Mr. Bush’s antagonists will shriek that he is cutting benefits. His backers will counter that those benefit promises are empty because Social Security can’t pay them. My point is neither to praise nor to condemn the Bush plan, but to describe what he probably will offer.

“What about those private accounts? ‘(Y)ounger workers ought to be allowed to take some of their own money and put it in a personal savings account, because ... they need to get better rates of return than the rates of return being given in the current Social Security trust,’ Mr. Bush said last night.

“The accounts will be there, but they haven’t anything to do with fixing Social Security finances. They’re the dessert to get people to swallow the spinach. The plan probably would allow workers to divert 2% of wages, perhaps as much as 4%, into private accounts. That would mean less money from the 12.4% payroll tax (split between workers and employers) going into the Social Security pot. In exchange, workers who opt for private accounts would agree to even smaller benefits in the future than those provided by the formula change. Over the long haul, the Bush team says, it’s a wash for Social Security: Tax revenue diverted to private accounts is supposed to equal the benefits forgone by private account holders. Workers, they argue, should end up with more in retirement by taking the risks of investing in stocks and bonds.”

For Our Grandchildren: Young Working Women Need PRAs

Commentating in the New Hampshire [*Union Leader*](#), Leanne Abdnor and Heidi Neel of For Our Grandchildren emphasize the negative effects of Social Security on women. They depict the system as outdated and argue that it must be reformed to a system of PRAs in order to accommodate the future retirement needs of today’s young working women. The full text of the article follows.

“The 21st century woman in our country is free to choose what to do with her life. She chooses who to marry, if at all, and whether to divorce. She chooses whether to have children. She chooses where she wants to live, what work to do, and where to do it. She chooses whom to vote for, what groups to join, and whether she believes in a higher power. But she is not free to choose whether to make contributions to an unsustainable retirement system, from which she is legally entitled to nothing.

“The 21st century woman—a woman in her thirties—is stuck with a Social Security system that was created when her great-grandmother was probably a young woman in her thirties. At that time, women had been able to vote for only fifteen years. It was a time when women could not choose to have a television or a private telephone line in their homes, and it would be another fourteen years before she could buy cake mix!

“Since then, Social Security has served her great-grandmother and her grandmother very well. Even her mother is likely to get back more than she contributed to the system. However, the same is not true for today’s younger working women. This is because the taxes paid by our working men and women pay the retirement benefits of today’s elderly. For now, it’s more than enough to pay those benefits, but in a few years—about 2018—that won’t be enough.

“In the 1950’s, there were 16 workers paying the benefits of one retiree. Now, workers pay a whopping 12 percent of wages to the system because there are just three workers paying the benefits of one retiree. No money is saved for the future. All that is left is a stack of Social Security IOUs. Put in that stack of IOUs a copy of the Supreme Court’s 1960 ruling that no one has a guaranteed right to a Social Security benefit, and it’s indeed a shaky stack of paper sitting in the laps of our younger workers.

“If the measure of a moral society is the kind of society that it leaves to its children, it is time to act quickly. First, we must take care of our retirees, including our grandmothers and our mothers who are near retirement, by ensuring that they receive all their promised Social Security benefits. Second, we must strengthen the protections against poverty in old age by increasing the Social Security minimum benefit. Third, we must pull our Social Security system out of the ruins of the 1900s and modernize it by giving choices to our younger working women.

“It’s time that our 21st century working woman be given the choice to decide for herself if she wants to put a portion of her Social Security taxes in an individually owned and controlled personal retirement account (PRA). She could choose to invest among just a handful of government-regulated mutual funds, including a fund containing risk-free government bonds. Or, she could choose to invest in a fund with stocks. If she were a divorcee, she would take with her half of the couple’s accumulated PRA earnings. She could choose to transfer her money among the various funds as she got closer to retirement age. And, at retirement, she would still have a Social Security benefit—although smaller—and could choose to turn her PRA into an inflation adjusted annuity or leave the money to her children, nieces or anyone she chooses.

“We women have many things for which to be grateful—including the right to live in this great country and choose how we want to live our lives. Whether to create a nest egg for our own retirement years should be among the choices we have.”

Bill Frenzel: Young People Deserve Better than What Social Security Can Offer

Writing this week [in the *Minneapolis Star Tribune*](#), former congressman and member of the president's Commission to Strengthen Social Security Bill Frenzel argues that today's young workers deserve better than what Social Security will have to offer them when they retire. Citing the confluence of factors that have contributed to Social Security's financial problems, Frenzel argues that the United States should move to a system of private retirement accounts now—as other countries have already done—to create opportunity for today's young workers. The text of his commentary follows.

“Young people who will retire in 2035 should not be forced to live with a Social Security system that was invented in 1935.

“The world in 1935 was a much different place: Americans couldn't drive across the Golden Gate Bridge, view the completed Mount Rushmore, use Tupperware or eat their Cheerios because none of those things existed. In 1935, cellphones, supersonic flight, space travel and robotics were all the stuff of science fiction. As a nation, we have changed with the times. But the Social Security system is rooted in Depression-era thinking. It is time to bring Social Security into the 21st century.

“Certainly, we must applaud the success of the Social Security program. Through payroll taxes and benefit payments, Social Security touches more Americans than any other federal program. To its credit, the Social Security retirement system has kept millions above the poverty line since 1935 and today 50 percent of retirees depend on it to provide more than half of their monthly income.

“Despite its successes, though, the Social Security retirement program will be stressed when Baby Boomers start retiring at the rate of 10,000 a day in 2008. Somehow we need to find a way to provide for the Baby Boom retirees without penalizing generations to come.

“What are some of the factors that require new thinking? First, when Social Security was enacted, the average life expectancy was age 60. Today, thanks to health and medical advancements, it is 78. In fact, those over 80 years of age are now the fastest-growing segment of our population.

“Second, 30 years ago there were five workers supporting every Social Security recipient. Today that ratio is 3.4 workers per retiree. By 2030 (when the Baby Boom generation is fully retired), the ratio will be 2-1.

“Third, and most importantly, current payroll tax surpluses are not being saved for the future, meaning that the Social Security Trust Fund is essentially a stack of IOUs.

“Is it any wonder that a growing number of younger workers take it as a matter of faith that the Social Security program won't be around for them when they retire?

“Faced with similar circumstances, many other industrialized nations have taken steps to reform their government retirement policies. In Great Britain and Australia, for

example, a pay-as-you-go Social Security system has been replaced with one that allows workers to invest part of their payroll taxes in the stock or bond market. A basic safety net is retained, but workers in these nations now have the opportunity to create a retirement nest egg for themselves beyond the safety net.

“The United States would do well to enact similar reforms.

“Polling data shows that most Americans support private investment accounts as part of Social Security, with overwhelming support coming from younger voters.

“Young Americans understand that Social Security in its present form cannot offer them the same security that it has provided for their grandparents. They are rightly concerned that they will be forced to pay more into the system, while getting less back. In fact, one poll of voters under 30 discovered that a greater number of young people believed in UFOs than in the likelihood that Social Security would be there for them.

“By large margins, these same young voters are strongly in favor of the option of investing a portion of their payroll taxes in a mutual fund. In short, they want some sense of control over their financial future.

“Can we honor our commitment to those currently retired or soon to retire, while moving toward a system that helps workers establish personal savings accounts? Of course we can. President Bush’s bipartisan Social Security commission, on which I served, has suggested three alternatives that achieve this objective at less cost than maintaining the status quo. Certainly, reforming Social Security will be no free lunch.

“Inevitably, some benefits will need to be curtailed in order to make the Social Security system affordable over the long term. But significant benefit cuts and/or tax increases will need to occur simply to shore up the current system. All the more reason to establish private accounts so that younger workers have the opportunity to create wealth for themselves.”

Peter Ferrara: Critics of PRAs Overestimate Administrative Costs

In a commentary appearing in the *Washington Times*, Peter Ferrara of the Institute for Policy Innovation refutes the claims of University of Chicago professor Austan Goolsbee, whose controversial paper on partial privatization of Social Security has been widely touted by the Kerry campaign. Using the Ryan-Sununu reform bill as an example, Ferrara argues that Goolsbee’s estimates on the administrative costs of private accounts are wildly exaggerated. The text of his commentary follows.

“Statistics and studies produced by political campaigns are notoriously unreliable. The Kerry campaign is now distributing one of the greatest whoppers of all time in regard to Social Security.

“The claim is that allowing personal accounts for Social Security, as President Bush proposes, would result in \$940 billion in administrative fees going to private

financial management firms (read Wall Street) over the next 75 years. This figure was concocted for John Kerry by Professor Austan Goolsbee of the University of Chicago.

“But to reach this conclusion, the good professor assumed the administrative fees for the personal accounts would run 0.8 percent yearly, or 80 basis points. This is a gross overstatement of the administrative costs for efficiently structured personal accounts, becoming particularly absurd as the accounts grow to huge levels over 75 years.

“The chief actuary of Social Security, in scoring personal account reform plans, assumes an administrative fee of 25 basis points (0.25 percent) for well-structured personal accounts, such as those proposed in legislation recently introduced by Rep. Paul Ryan, Wisconsin Republican, and Sen. John Sununu, New Hampshire Republican. On this basis, Mr. Goolsbee’s calculation overstates the administrative costs more than threefold. At 25 basis points instead of 80, Mr. Goolsbee’s \$940 billion becomes \$312.5 billion (again over 75 years).

“But even this is an overstatement. For the accounts would grow to huge levels over time, and the administrative fees as a percent of total accounts assets would decline sharply. The administrative costs for the federal employee Thrift Savings Plan, for example, are only 9 basis points. The personal accounts in the Ryan-Sununu plan would operate quite similarly to this Federal Thrift Savings Plan.

“After the first five to 10 years, as the personal accounts grow over time to trillions of dollars, administrative fees would fall from the initial 25 basis points assumed by the chief actuary, to 10 points or even less. At 10 basis points, Mr. Goolsbee’s \$940 billion becomes \$117 billion (again over 75 years).

“These administrative fees need to be put in perspective. The chief actuary projects the personal accounts proposed by Ryan-Sununu, for example, would grow to more than \$7 trillion in the present value dollars used in the Goolsbee calculation. This would be money workers directly owned in individual accounts.

“At standard, long-term market investment returns, workers would earn returns on those funds of \$385 billion (assuming half invested in stocks and half invested in bonds). At 25 basis points, administrative fees for the year would be \$17.5 billion, leaving workers with a net gain of \$367.5 billion for the year.

“But \$17.5 billion in fees for one year is still a stupendous amount, far, far more than would be needed. At 10 basis points, the fees would be \$7 billion for the year, leaving workers a year’s net gain on their \$7 trillion of \$378 billion.

“But \$7 billion for one year of fees is still huge, and even that may be more than necessary. That is why estimates of administrative fees of more than 25 basis points become so absurd as the funds grow to huge amounts over time.

“Under the Ryan-Sununu bill, the federal government would retain control over the amount of administrative fees chargeable for the personal accounts. Consequently,

over the long run, there is just no way those fees will be more than roughly 10 basis points, or 0.1 percent.

“The best work ever done on the administrative costs of personal accounts was that of William Shipman, a former principal at State Street Global Advisers, one of the world’s largest asset management firms. Mr. Shipman used the internal pricing programs of State Street to calculate what it would charge to manage well-structured personal accounts.

“Mr. Shipman found that with workers allowed to shift only about 2 percentage points of the total 12.4 percent Social Security payroll tax into the accounts, the administrative costs would start at roughly the 25 basis points assumed by the chief actuary of Social Security. But after five to 10 years, even these costs start declining sharply, ultimately to less than 10 basis points.

“With larger accounts allowing a shift of 6 percentage points of the tax, similar to the accounts proposed in Ryan-Sununu, the administrative costs start out at only 7 to 12 basis points. As the accounts grow huge over time, even this declines sharply.

“That is why the blather about administrative costs for personal accounts is just an overhyped campaign fairy tale.”

Publications

The Social Security Administration has released the latest issue of its newsletter “[International Update](#).” The publication for September looks at the most recent international developments concerning pension reform. This month’s issue discusses movements toward reform in Poland, Sweden, Nigeria, the Bahamas, and Canada.

In a brief analysis recently released by the National Center for Policy Analysis, NCPA senior fellow and public trustee of Social Security and Medicare Thomas R. Saving says we cannot delay the crisis in Social Security funding any longer. Saving’s analysis can be seen [here](#).

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