



# Social Security Choice

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

A WEEKLY NEWSLETTER ON SOCIAL SECURITY REFORM

WEEK OF DECEMBER 17, 2004

### ***New Study Says No Wall Street Windfall from Reform***

Plans to reform Social Security so that workers can invest a portion of their income in the stock market are unlikely to produce a windfall for Wall Street, according to a new [study](#) by the Securities Industry Association (SIA).

If investment choices are limited to a small number of index funds—along the lines of the Thrift Savings Plan that is available to federal workers—the new private accounts will generate only \$39 billion in fees over the first 75 years, or just 1.2 percent of estimated revenue for the entire financial sector during that time span.

Even a plan that allowed a wider range of actively managed mutual funds would generate at most \$279 billion in fees, said Rob Mills, director of industry research at the SIA. That number is still far lower than the \$940 billion estimate cited by Austan Goolsbee of the University of Chicago's Graduate School of Business.

A well-configured personal account system should ensure that individuals get a market return on their savings at minimal cost and with minimum complexity, says the SIA.

### ***Shipman: Market-Based System Less Costly Than Status Quo***

Opponents of Social Security reform argue that the “transition costs” associated with a system of personal accounts would be too large a burden to bear in the near future. But this argument doesn't consider the costs that the existing system will incur if left untouched, says William G. Shipman in an *Atlanta Journal-Constitution* [op-ed](#) (registration required).

Leaving Social Security unreformed will force the government to borrow about \$4.5 trillion in present value terms to pay all promised benefits until 2078. To phrase it

differently, each American family would have to give the government about \$43,000 today, plus pay payroll taxes currently stipulated by law, in order to afford the benefits that have been promised until 2078. A system of market-based personal accounts would not only be less costly in the long run, but would allow low-income workers to accumulate a nest egg that they, not the government, would own, according to Shipman, who co-chairs Cato's Project on Social Security Choice:

"...This argument does not consider the costs of the existing system should it not be reformed. According to Social Security's trustees, this would lead to payroll taxes being insufficient to pay all benefits by about 2018. Let's further assume that the government at that time borrows the difference so that all benefits are honored.

"Such borrowing would continue through 2078 and then well beyond because the demographic trends that cause the imbalance are well established and not subject to meaningful change. The trustees estimate that total borrowing only to 2078 would be about \$4.5 trillion in present value terms.

"Another way of presenting this is each American family would have to give the government about \$43,000 today, plus pay payroll taxes stipulated in present law in order to afford promised benefits.

"Now let's assume we reform the system as broadly outlined by Bush. First of all, not everybody is going to jump on the president's idea, and for good reason. A 64-year-old wouldn't want to budge from the current program because he wouldn't have sufficient working time left to save and invest enough to replace what he would otherwise receive from the government program.

"Conversely, a 21-year-old would opt for the personal account because he does have time to accumulate enough wealth on which to retire with benefits that most likely would be far greater than those from Social Security.

"Let's assume all workers older than 35 would stay with Social Security, pay the full payroll tax and receive the stated benefit. All workers younger than 35 would choose the market-based alternative, save and invest part of their payroll tax for their retirement and continue to pay the remainder of the payroll tax to the government to help provide for those who stay with Social Security. The government is largely off the hook for them and fully off the hook for all new, younger workers who enter the labor force.

"The government's liability, therefore, is now capped at the benefits payable to those over 35 and the much lower accrued benefits of those under 35. Starting almost immediately, the total number of workers and retirees in the older group shrinks because of death and the fact that no one enters the group.

"When the last person dies, the government's benefit payments drop to zero. The government's ongoing liability for the younger group phases out as well because more

and more people of this expanding group provide for themselves exclusively through their personal accounts.

“It is true that achieving President Bush's vision for modernizing Social Security will require a transition period, bridge financing and an earlier date when we experience negative cash flows.

“But under all reasonable assumptions, a market-based Social Security system will, over the long run, always be less costly than remaining with the present tax-funded structure.”

### ***Krugman vs. Krugman***

One of the most vociferous critics of President Bush's proposals to allow younger workers to privately invest a portion of their Social Security taxes through individual accounts has been economist and *New York Times* columnist Paul Krugman. In recent months, Krugman has repeatedly written that there is no Social Security crisis, claiming the program is solvent until at least 2042—and sometimes 2052—and can be adjusted after that with only minor changes. Social Security, he says, is an “invented crisis.”

However, as Tim Wood of *Resource Investor* reminds us, Professor Krugman has not always seen it that way. When Bill Clinton was president, Krugman was a charter member of the “save Social Security first” club, writing:

“Social Security ... does not look like a redistributionist scheme. In practice it has turned out to be strongly redistributionist, but only because of its Ponzi game aspect, in which each generation takes more out than it put in.

“Well, the Ponzi game will soon be over, thanks to changing demographics, so that the typical recipient henceforth will get only about as much as he or she put in (and today's young may well get less than they put in).”

-- *The Boston Review* (December/January, 1996-7)

“But aren't Social Security and Medicare basically pension funds, in which workers' contributions are invested to provide for their retirement? Hardly. A private pension fund that planned to pay the benefits these programs promise would be accumulating huge reserves. In fact, the so-called “trust funds” are making barely any provisions for the future.

“... the Federal Government... is in fact living utterly beyond its means. While the present generation of retirees is doing very nicely, the promises

that are being made to those now working cannot be honored.

“....to avert the crisis ahead.....slow the growth in benefit levels, gradually raise the retirement age, impose limits on expensive terminal medical care that prolongs life for only weeks or days and—last but not least—raise taxes moderately now, rather than massively later.

“....Something is bound to give—but what?

“Will retired boomers—who will have even more political clout than today’s smallish population of retired voters—be willing to accept a sharply reduced standard of living? That is hard to imagine.

“Will younger voters be willing to accept huge increases in tax rates to support the boomers in the style they have been promised? That is equally hard to imagine.

“Or will the Government try to square the circle by simply printing the money it needs, creating runaway inflation? Surely that is inconceivable. Yet one or more of these unthinkable things will happen, because something must.”

-- *New York Times Book Review* (Oct. 20, 1996)

The inescapable demographic and economic evidence is that Professor Krugman got it right the first time.

### ***José Piñera: Chile’s Pension System a Model of Reform***

About half of all Chileans participate in the country’s private pension system, investing 10 percent of their monthly income into retirement accounts that they own and manage. Workers can choose from among six investment funds regulated by the government, and returns have averaged 10.3 percent per year since 1981 with inflation factored in.

Cato senior fellow José Piñera was the architect of the Chilean private pension system in 1980 while he was secretary of labor and social security. Piñera, who also founded the International Center for Pension Reform, is an ardent advocate of replacing government “pay-as-you-go” social security systems with private pensions where workers invest their earnings to save for retirement. The following are excerpts from a recent *Associated Press* [interview](#) with Piñera:

**“Question:** Chile’s military and police decided not to be part of the privatized system when it was established and kept their government-funded pensions. Did the military and police get a better deal?

**“Answer:** Because of ignorance, prejudice and Prussian military formation, they inflicted on themselves the worst possible deal. ... The military have missed a 10 percent real return on their contributions over 23 years. And their bankrupt pay-as-you-go, government-run system ... leaves them hostage -- and very, very pliable -- to whoever is in government. ... The incident proves how difficult [it] was making these reforms in a military government, given that their formation is generally pro-government and pro-centralization.

**“Q:** Returns on the funds have been phenomenal since the start, largely because of Chilean privatization, but are expected to be lower in the future. What can be done to try to ensure the types of returns realized so far?

**“A:** Expected by whom? How do they know so much about the future? Facts are facts. Expectations are, well, expectations, not a basis for analysis. There is a whole industry of pessimistic forecasting. Beware of them. Remember that I explained the new system on TV to all the country [predicting] only a 4 percent rate of return. It has been 10 percent real on average for 23 years. ... Continue the privatization process. Return to the economic policies that led to 12 years of 7 percent plus economic growth. Stop discouraging investment by announcing new taxes every month.

**“Q:** The similarities between the Chilean system and American voluntary 401(k) retirement funds are striking, yet one element is missing from the Chilean system that motivates Americans to participate in their 401(k) plans: employer matches. Yes, businesses would scream if they had to participate, but wouldn’t it be a psychological impact that would increase savings?

**“A:** No. There is a fundamental difference. In many 401(k) [plans], the employer decides or influences the investment allocation and generally ends putting a large fraction of the workers’ retirement money in their own stock [as at Enron]. That is putting your job and your pension in the same risk basket. A huge mistake of concept. The beauty of the Chilean system is the complete divorce from the company where you work and the companies where your pension is invested. ... We all know from kindergarten economics that mandated employer contributions ultimately come from the worker's wage. ... The fraudulent way to increase payroll taxes is to label half of them as employer contributions, and then politicians dare to increase them at will, despite the fact that wages will come down by that amount following market pressures. ... I prefer not to give psychological arguments—so convenient to support anything—but stick to economics and common sense.

**“Q:** Chileans of all classes seem to lack knowledge or interest determining savings needed to reach retirement goals. What is the extent of this problem, and how can it be overcome?

“A: I do not have a definite assessment on this since it is a highly empirical issue. Now, it is true that it is part of Latin culture [to leave] things for the last moment in every aspect of life. Of course, the government, the [fund administrators] association, modern trade union leaders, etc., should do more to create a culture of responsibility in societies that have had a weak one for 500 years. And it takes time. What is absolutely clear is that a defined contribution system, or capitalization system, clearly encourages responsibility, while a defined benefit system, whether government or private, clearly encourages indifference.”

## ***NCPA Releases New Personal Account Plan***

The Dallas-based National Center for Policy Analysis (NCPA) on December 9 presented a new plan to reform Social Security. According to Thomas R. Saving, an NCPA senior fellow who is also a trustee of the Social Security and Medicare trust funds, the NCPA plan is the first that spells out how to fund the transition from the current pay-as-you-go system to private accounts without borrowing money.

The NCPA plan would allow all workers who have not reached retirement age to divert part of their payroll taxes into a personal retirement account, with lower-income workers allowed to deposit more than higher-income workers. Workers who choose the personal account option would make an additional contribution of 1.25 percent of their wages, an amount that would then be matched by their employer.

Employees and employers would be allowed to meet the additional account requirement by diverting contributions currently made to their defined-contribution plans, including 401(k)'s, for the first five years. Deposits to the personal retirement accounts would be fully funded by expected Social Security surpluses, the Social Security trust fund, and additional savings by workers and their employers.

After about three decades, the reformed Social Security system would be self-financing, with the youngest workers fully funding their own retirement, relying on the government only if their retirement income fell below the poverty level.

The full NCPA report can be read [here](#).

## ***Las Vegas Review Journal Endorses Cato Plan***

A recent [editorial](#) in the *Las Vegas Review Journal* applauded Cato's Social Security reform plan for urging cuts in corporate welfare and other pork barrel spending as one way to finance the transition to personal accounts. Cato analysts found more than \$87 billion in wasteful government subsidies to corporations that could be

eliminated from the budget. Lawmakers should avoid raising taxes to fund Social Security reform and focus instead on cutting wasteful spending. Excerpts from the article follow:

“A presidential commission in 2001 proposed allowing individuals to place up to 2 percent of their paychecks into a private account to be invested for retirement—the plan Mr. Bush favors. But because any such plan would divert funds into individual retirement accounts actually belonging to the taxpayer, it would increase shortfalls in the traditional government program.

“But raising taxes is not the only way to cover such a transitional shortfall. The Cato Institute has proposed its own, much more dramatic, plan, allowing individuals to invest their full 6.2 percent of earnings into individually owned, privately invested accounts. Workers choosing this option would receive a bond, representing the sum already paid into the system, redeemable on retirement, and would thereafter earn no further benefits from traditional Social Security.

“Those who wished to remain in the traditional Social Security system would be free to do so.

“But even such a far more dramatic transition could be funded simply by ‘cutting corporate welfare and other pork barrel spending,’ the Cato analysts find. ‘The Cato Institute has identified more than \$87 billion each year in wasteful government subsidies to corporations,’ they note.

“Surely that’s a way to finance Social Security reform that even Democrats can embrace.”

### ***Commissioners Discuss Reform “Model 2”***

President Bush has committed himself to pushing Social Security reform during his second term, and he said recently that the recommendations of his 2001 Bipartisan Commission to Strengthen Social Security should be the ‘starting point’ of the negotiations with Congress.

In a recent [op-ed](#), two members of the commission, Leanne Abdnor and former Democratic congressman Tim Penny, outlined the details of “Plan 2,” the reform proposal that was supported by most of the commission’s members. Plan 2 recommended several steps to reform Social Security: First, everyone who is age 55 or older should receive their promised benefits, inflation adjusted. Second, Social Security’s “safety net” should be strengthened by increasing the benefits paid to low-income workers. Third, because the current benefit formula increases the benefits of future retirees beyond the amount received by today’s retirees, even after inflation, the growth in benefits should be cut.

Finally, younger workers should be given the choice to invest four percent of their income (or up to \$1,000 for low-wage workers) in an individually owned, controlled, and inheritable personal retirement account.

According to Abdnor and Penny, the transition costs associated with reform would be significantly lower than opponents have alleged—the Social Security actuaries' analysis said that Plan 2 would cost \$700 billion over the next ten years. The commission's full bipartisan report can be viewed [here](#).

### ***Mitchell and Saving: Inaction Is the Enemy on Social Security Reform***

To get the ball rolling on Social Security reform, Americans need a clear sense of the situation and the consequences of inaction, argue Thomas R. Saving and Olivia S. Mitchell in a recent *Los Angeles Times* [op-ed](#) (registration required). The debate on Social Security reform is being clouded by claims that creating personal retirement accounts would come with huge “transition costs” that we otherwise would not face.

However, financing the transition to a system of personal accounts would cost far less over the years than having to raise payroll taxes 50 to 80 percent to maintain Social Security as it exists:

“As is true for all important public policy issues, the proposals for fixing Social Security don't condense easily into simple sound bites. Right now, the debate is being clouded by the claim that creating personal Social Security accounts would give rise to huge ‘transition costs’ that we otherwise would not have to face.

“In reality, the question isn't whether or not there will be costs involved in dealing with Social Security's problems, but how much they will be and when they will be paid.

“Let's clear the air by reviewing key facts about Social Security. First, the good news: Today's retirees and those nearing retirement will get their benefit checks. Currently, the Social Security system takes in more in taxes than it uses to pay benefits each year.

“Next, the bad news: In less than 15 years, a shrinking workforce and the retirement of the baby boom generation will result in payroll taxes falling short of what is needed to continue paying Social Security benefit checks. At that point, the system will begin to draw down the Social Security trust fund, made up of surplus payroll taxes previously paid into the system.

“Unfortunately, the trust fund is full of IOUs because the government has not saved these surplus payroll taxes. The trust fund simply represents the promise of one part of government (the Treasury Department) to another part (the Social Security Administration) to find those dollars when they are needed.

“How much are the IOUs worth? \$1.9 trillion. To come up with that, other government programs will need to be cut, taxes will need to be raised or new borrowing will need to occur. And even then, the Social Security actuaries tell us that by 2042 the trust fund will be used up, and there will still be a substantial shortfall between promised benefits and the amount payroll taxes bring in.

“Which brings us to the ugly: When the trust fund runs out, benefits will have to be cut by 30% or payroll taxes will have to rise by 50% to 80%.

“When you put the good, the bad and the ugly together, what you’ve got is this: Over the next 75 years, the shortfall between payroll taxes and promised benefits will total \$26 trillion (in 2004 dollars). If we had \$10 trillion that we could invest right now, we could meet that obligation, but \$10 trillion is about the size of the entire U.S. economy. Talk about ‘transition costs’!

“That brings us to finding a way to make Social Security sustainable and solvent for the long run. The bipartisan President’s Commission to Strengthen Social Security, convened by President Bush in 2001, proposed offering voluntary personal retirement accounts, similar to 401k plans and reducing the growth rate of future benefits.

“Over the long term, the cost of the commission’s proposal is far less than having to raise payroll taxes 50% to 80%. In fact, the Social Security Administration estimated that the commission’s approach would cost about \$700 billion — much less than the \$2 trillion bandied about by the opponents of personal Social Security accounts.

“Every year we delay reform of the Social Security system we lose options. We are closing in on the point at which payroll taxes will fall below promised benefits, and we must act to restore the system’s crucial role in retirement security.

“Americans need a clear understanding of the situation and the costs and benefits of reform. To get the ball rolling, we should start by recognizing the costs of doing nothing and the consequences of inaction.”

## **The Economist *on Social Security Reform and Debt***

How much borrowing will be necessary to transform Social Security from a tax-financed program into one based on private accounts? An article in this week’s *Economist* analyzes different reform plans and the amount of borrowing each would require, concluding that any new debt won’t necessarily be a large burden, as the government would merely be reducing its implicit future liabilities and increasing its explicit current liabilities. In theory, efficient financial markets would realize this and would not demand higher interest payments on government bonds. Excerpts from the article follow:

“On December 6th a White House spokesman confirmed that Mr. Bush’s plans would indeed mean more borrowing. How much more depends on the details. At the modest end of the current proposals is an idea put forward in 2001 by the Commission to Strengthen Social Security, which Mr. Bush appointed. This would allow individuals to switch four percentage points of their payroll-tax contributions, up to a maximum of \$1,000, into individual accounts. Their promised benefits from Social Security would be cut, though by less than the amount of diverted revenue plus interest. To plug the long-term hole in Social Security’s finances, promised benefits would be cut for everyone. Extra borrowing of \$1.5 trillion-2 trillion over the next decade would be required, but the state pension programme's unfunded liabilities would eventually be wiped out.

“Some conservative Republican Congressmen are pushing a more dramatic idea. They would like to divert up to half of payroll-tax contributions to individual accounts. Some of them would guarantee that total benefits (i.e., public plus private) would not be cut, and would rely on spending cuts elsewhere in the budget, high investment returns and tax revenue from higher economic growth to make the numbers add up. Meanwhile, the government would have to borrow much more than under the commission’s plan: \$5 trillion over the next decade alone. By way of comparison, America now has \$4.3 trillion of government debt outstanding.

“All this new debt sounds frightening, but advocates of reform say that borrowing now will help stave off problems in the future. If Americans have individual accounts and therefore receive less from the state when they retire, Social Security’s future liabilities will be reduced. It is worth borrowing now and paying interest in order to bring this about. To make this purpose clear, Republican lawmakers want borrowing related to Social Security not to be counted in the government's normal accounts.

“Opponents are aghast. Big increases in borrowing, they fear, will widen America’s already gaping budget and current-account deficits and push interest rates up. Trying to hide the profligacy by fiddling the government accounts (one or two critics have muttered “Enron”) will fool no one.

“Who is right? In theory, creating private accounts need not make the hole in the government’s finances bigger than it already is. The government is merely reducing its implicit future liabilities and increasing its explicit current liabilities. If financial markets are efficient, they should spot this and ought not to demand higher interest payments on government bonds. The current-account deficit (the difference between national spending and national income) need not widen because national saving would be unaffected by the reform. Although the government would be borrowing more to make up for the money diverted into individual accounts, private saving would rise by exactly the same amount.

“In practice, the macroeconomic consequences might be less benign. First, it is not clear that financial markets will treat explicit government debt in the same way as implicit future promises to tomorrow’s retirees. It is much easier to renege on the latter than to default on the former: Wall Streeters have probably assumed that some of that \$4 trillion gap in Social Security will not be filled in any case.

“Second, it is hard to be sure about the effect of debt-financed reform on national saving. It is possible that saving might rise, if the very existence of private accounts encourages low-saving Americans to take responsibility for their retirement and put aside more money. It is also possible that Americans might save less, if they believe that individual accounts are a more reliable means of support in old age than the existing system.

“In any event, the creation of private accounts will not in itself eliminate the unfunded liabilities implicit in today's pension system. That, however, is what the politically alluring proposals from some Republicans in Congress seem to assume. But as Gregory Mankiw, head of Mr. Bush's Council of Economic Advisers, said recently, there is no free lunch: if the sums are to tally, and if higher taxes are off limits, benefits will have to be cut. The question is whether Mr. Mankiw's boss will listen.”

## ***Publications***

Last May, the Michigan Retirement Research Center and the Social Security Administration Office of Policy held a half-day workshop that brought together subject area experts to examine the present and future impacts of global aging on social insurance programs. The transcript of the event is now available [here](#).

## ***Events***

The Cato Institute will hold a two-day conference on Social Security February 8–9, 2005. Confirmed speakers include Nobel Laureate Edward Prescott, as well as Lea Abdnor, Andrew Biggs, Robert Bixby, Jesse Brown, Robert de Posada, Martin Feldstein, Jagadeesh Gokhale, Stephen Goss, Douglas Holtz-Eakin, Rep. Sam Johnson (R-TX), Rep. Jim Kolbe (R-AZ), Maya MacGuineas, Thomas Saving, Kent Smetters, and Michael Tanner, among others. For more information or to register click [here](#).

## ***Job Opening***

**Project Manager:** Cato's Project on Social Security Choice is looking for a project manager to coordinate and implement its communications, administrative, and outreach efforts. Successful candidates should have outstanding oral and written communication skills. Public relations, campaign management, or grassroots activism experience is highly desirable, as is knowledge of the current debate over Social Security reform. The job involves designing and managing strategies for communicating Cato's message on Social Security reform to specific target audiences, community activists, and the general public. Responsibilities include arranging speaking engagements for Cato

scholars, writing press releases, managing the content of Cato's Social Security website, creating Social Security materials and managing their distribution, designing paid advertising campaigns, coordination with other groups interested in Social Security reform, ensuring interdepartmental coordination and communication particularly with the communications and government affairs departments, and other public relations, administrative, and media-related duties. Submit résumé and writing samples to Michael Tanner, Cato Institute, 1000 Massachusetts Ave. NW, Washington D.C. 20001, or to [mtanner@cato.org](mailto:mtanner@cato.org).

***NOTE: Due to the upcoming holidays, Social Security This Week will not be published December 24 or 31. It will return on January 7.***

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