It's *your* money

A Citizen's Guide to Social Security Reform

Ownership • Inheritability • Choice

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Printed in the United States of America.
Cover design: Jon Meyers

Cato Institute
1000 Massachusetts Ave., N.W.
Washington, D.C. 20001
www.cato.org

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Cato Institute Project on Social Security Choice
1000 Massachusetts Avenue, NW
Washington, DC 20001

www.socialsecurity.org

A Message from Ed Crane

The Cato Institute has prepared this booklet as a clear, concise, understandable presentation of the issues surrounding Social Security reform. While Social Security does face the prospect of a serious funding shortfall in the not-too-distant future, we believe that far too much of the debate to date has focused on "green-eyeshade" issues such as insolvency dates, transition costs, rates of return, and unfunded liabilities. Those are complex accounting and actuarial issues that can and will be solved.

Far more important from our perspective are three fundamental problems with the current structure of Social Security. Any successful Social Security reform must address these problems. First, as confirmed by the Supreme Court in 1960, Americans have no ownership rights to the money they pay into Social Security. The federal government has no contractual obligation of any kind. What you get back—and, indeed, the age at which you qualify to receive benefits—is entirely up to the 535 men and women in Congress. That is simply wrong. It is your money. You work hard for it. You should own it.

Second, because there is no ownership, there is also no inheritability. When you and your spouse pass away, the money simply disappears. A reformed Social Security system should ensure that the money you pay into Social Security your entire working life goes to your loved ones. Finally, there is no choice under the current system. You are forced to participate in a retirement system with very little return, no ownership, and no inheritability. Under the reform plan proposed by the Cato Institute, you could opt to participate in a new system of personal accounts with ownership and inheritability or you could stay in the current system.

The essence of America is a respect for the dignity of the individual. It seems obvious that when individuals have more control over their own lives, their dignity is enhanced. That is what personal accounts will do for all Americans. I hope you'll find this a valuable booklet and that you'll share it with your friends and neighbors.

Edward H. Crane
President, Cato Institute

Social Security:

Why We Need Reform

The debate over Social Security reform has generated many competing claims and confusing projections. But the most important issue is this: Will the current Social Security system provide our children and our grandchildren with a secure and comfortable retirement? Since the answer to that simple question is no, there's no denying the need for reform.

This booklet explains the state of the Social Security system today and describes how we can fix the flaws in its structure that, if left unchanged, will burden our children and grandchildren with unnecessary debt and taxes. The good news is that, with revisions to the Social Security system, we will be able to provide future generations with a program that actually accomplishes more successfully what the creators of the original Social Security program hoped to achieve—real retirement security.

Social Security Can't Pay What It Has Promised

Social Security was established in 1935 to provide old-age retirement benefits for American workers. Later, the program added survivors' and disability benefits. Now, 70 years later, it is reasonable to ask, "Is Social Security doing what it was established to do?" Today, the program faces a severe financial problem: it will not be able to pay the benefits it has promised to today's younger workers. By 2017 Social Security will begin

to run a deficit, paying out more in benefits than it takes in through taxes. In sum, Social Security owes roughly $12.8 trillion in benefits that it cannot pay.

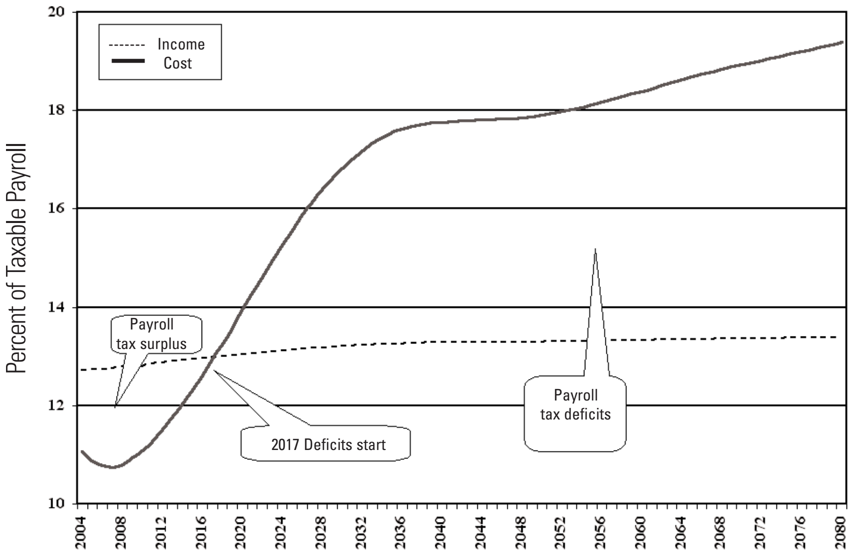
Today's young workers already pay incredibly high payroll taxes relative to the benefits they'll receive. Cutting benefits and raising taxes even more will make Social Security an even worse deal in the future, providing a low, below-market rate of return.

We must act now so that we can all benefit from a national retirement program that makes wiser, more efficient, and more profitable use of our hard-earned money. Though it may seem that everyone has a plan for reforming Social Security, some ways are better than others. Simply raising taxes and reducing benefits might "save" Social Security financially, but solvency is not enough.

The best way to ensure that Social Security does what it was intended to do—help provide a secure and comfortable retirement—is through a system of personal retirement accounts, which will allow workers to privately save and invest their Social Security taxes.

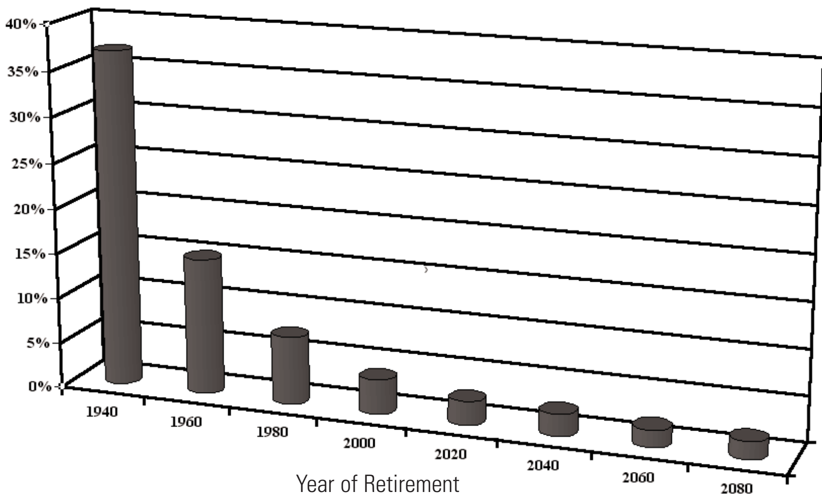
Social Security's Financial Crisis

Today, Social Security is running a surplus, but deficits will begin in 2017 and grow ever larger.



Social Security Administration

Social Security's Declining Rate of Return



In this booklet, you will see how personal accounts can

- give workers ownership of and control over their retirement funds;
- help restore Social Security to long-term solvency, without massive tax increases;
- provide workers with higher benefits than the current system can pay;
- create a system that treats women, minorities, and young people more fairly;
- make Social Security benefits inheritable, so workers can pass their savings on to their loved ones; and
- allow low-income workers to accumulate nest eggs of real wealth for the first time in their lives.

Social Security vs. Personal Accounts

Social Security currently operates through pay-as-you-go (PAYGO) financing. That means that as money comes into the system through the payroll

taxes of current workers, it goes right back out as benefits to current retirees. It is simply a transfer of wealth from the young to the old. In contrast, a system of personal accounts would be prefunded. The taxes paid by workers would be saved in personal accounts that would belong to the workers and grow over their lifetimes.

A side-by-side comparison shows why a prefunded system of personal retirement accounts is preferable to PAYGO financing.

How the Systems Work

Current System	Personal Accounts System
A portion of your income is paid to the government as a tax.	A portion of your income is put into an account that you own.
The government immediately uses your tax money to pay the benefits of current retirees.	The money in your account increases in value through compounded interest and asset growth.
When you retire, the government pays your benefits from the taxes being collected from younger workers.	When you retire, you use the accumulated savings and investments in your account.
Your benefits are determined by the political process and can be changed at any time.	You own your own money and the government cannot touch it.
If a worker dies prematurely, the money he or she has paid in taxes goes to the government.	If a worker dies prematurely, the money in the account is passed on to his or her heirs just like other assets or property.

Ownership—The Most Important Issue

Though the financial problems facing Social Security are serious, there is a much bigger problem. As the preceding table makes clear, you don't own the money that the government collects from you for Social Security. Most people simply don't realize that *once you put money into Social Security through taxes, you no longer own it*. That means that (1) workers have no right to their Social Security benefits and (2) workers cannot pass on their accumulated Social Security retirement money to their heirs.

One of the most enduring myths of Social Security is that workers have a legal right to their Social Security benefits. People understandably assume that, because they pay Social Security taxes into the system their whole working lives, they have some sort of legal guarantee of the system's benefits. Unfortunately, the exact opposite is true.

Landmark Supreme Court rulings mean that you have no right to receive Social Security benefits. Congress and the president can reduce or even eliminate benefits at any time. In fact, Congress has already arbitrarily reduced Social Security benefits. For example, in 1983 Congress raised the retirement age, which amounts to a benefit cut. In addition, Congress can raise the payroll tax as it sees fit, with or without raising future benefits to reflect the higher taxes paid. Congress has raised the payroll tax an astonishing 21 times since the program was created. Given Social Security's looming financial crisis, additional benefit cuts or tax increases, or both, are guaranteed. Future lawmakers are under no obligation to keep the promises made today. The political nature of Social Security puts a worker's Social Security retirement benefits at considerable risk. *When Congress controls your money, there's no such thing as a guaranteed benefit.*

The second major problem arising from the fact that workers do not own the money they pay in Social Security taxes is that their heirs cannot inherit the accumulated retirement savings. Upon the death of the worker, no matter how much or how little he or she has paid in taxes or collected in benefits, the money paid into Social Security cannot be passed on to the worker's children or grandchildren. That loss is a particular burden on groups with shorter life expectancies who get less back in benefits relative to what they've paid. Low-wage earners in particular get a bad rate of return for themselves and have nothing to leave behind for their heirs.

The twin problems of no ownership and no inheritability can be solved by a Social Security system that features personal accounts. Personal accounts would provide workers with the benefits and safeguards of true ownership. Personal accounts would give all workers a legal right to their benefits. Social Security would no longer be a powerful political weapon, and workers and retirees would not have to worry that someone in Washington might cut their benefits. The money in workers' retirement accounts could be passed on to their spouses, children, churches, favorite charities, or whomever they wished. With personal accounts, you would own your retirement savings.

No Legal Entitlement

In the 1960 case of *Flemming v. Nestor,* the Supreme Court ruled that the taxes levied by the Social Security Administration are simply taxes like any other, and no individual has a right to any benefit based on paying the taxes. As the Court put it, "To engraft upon the Social Security System a concept of 'accrued property rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands." The Court also said, "The noncontractual interest of an employee covered" by the Social Security Act "cannot be soundly analogized to that of the holder of an annuity, whose right to benefits is bottomed on his contractual premium payments."

The Court's decision was not surprising. It was built on an earlier case, *Helvering v. Davis* (1937), in which the Supreme Court ruled that Social Security was not a contributory insurance program, saying, "The proceeds of both [the employee and employer] taxes are to be paid into the Treasury like internal-revenue generally, and are not earmarked in any way."

Therefore, under Social Security, your benefits are always subject to the whims of politicians in Washington. In contrast, with personal accounts, you would own your retirement funds, money that the politicians could never take away.

Concerns about Personal Accounts

So, why haven't we already moved to a system of personal accounts?

People have honest concerns about how personal accounts would work: How do we honor our commitment to today's retirees if we put Social Security taxes into personal accounts? What happens to those accounts if the stock market takes a plunge? How would such a system work? Those are important questions that advocates of Social Security reform must be prepared to answer.

Although personal accounts are better than the current system and will save trillions of dollars over the long run, there will be tough choices. But tough choices will exist no matter how we decide to fix Social Security's finances. And personal accounts are less expensive in the long run than attempting to merely preserve the current system.

Looking at all the benefits that personal accounts could contribute both to individuals and to the overall economic health of our country, the transition financing can reasonably be viewed as a manageable expense—an investment in our future fiscal health that would reduce the burden on workers, yield higher benefits for retirees, and deliver a stronger overall economy with higher wages. When you refinance your mortgage, for example, you pay the points up front. But your overall financial outlook is much better. The same is true of moving to a prefunded retirement system.

A large part of the transition from the old, struggling system to a new system of personal accounts could be funded by reducing existing government spending. Federal spending has increased roughly 40 percent in the last five years. Surely, in a $2.5 trillion annual federal budget we can find enough savings to help protect our children's retirement.

For example, we can choose to cut wasteful corporate welfare, reduce "pork-barrel" projects, and slow the expansion of other government programs. We can channel that money toward the creation of a Social Security system that actually works. Whatever form transition financing takes, the scheduled benefits of those at or near retirement must be protected.

Another common concern is that personal accounts would be too risky. Let's examine that. Certainly, we know that, in the short term, stocks can go down as well as up. However, when we are discussing personal accounts for Social Security, we are not talking about investing for one, two, or even five years; we are talking about investments over a working lifetime. *There has never been even a 20-year period in U.S. history during which you would have lost money in the stock market*. That remarkable statistic includes the period of the Great Depression, World War II, the "stagflation" of the 1970s, and the bursting of the dot.com bubble.

Moreover, creating personal accounts does not abolish the Social Security safety net. All the currently proposed plans include a minimum benefit, in some cases more generous than the current Social Security system provides.

Remember too that all the plans under discussion today are *voluntary*. If you believe that personal accounts are too risky, you are free to remain in the current Social Security system. But workers who want the better rate of return afforded by investments and the security of owning their own retirement assets should be given the opportunity to do so.

The Coming Financial Crisis

Is there a Social Security crisis? Some people might not agree with the term "crisis"—after all, Social Security checks to retirees will go out this month as promised. But most Americans recognize that the Social Security system put in place 70 years ago has serious problems that will result in the system's inability to pay promised benefits. Seventy-two percent of respondents in a *Washington Post* news poll in March 2005 said they believed the system was headed for crisis.

What Went Wrong?

The Social Security system that was created in 1935 relied entirely on pay-as-you-go financing to provide benefits for the first group of retirees.

Obviously, a pay-as-you-go system is very sensitive to the number of people paying in versus the number of people collecting benefits. In other words, the ratio of workers to retirees is crucial to the financing of the current system.

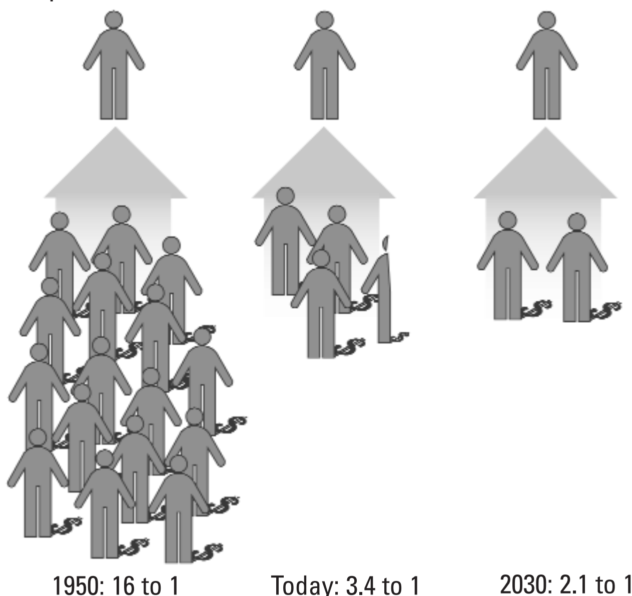
The current worker-to-retiree ratio in the United States spells trouble for Social Security and its ability to keep up with promised benefits. Today, people have smaller families, resulting in fewer new workers paying taxes into Social Security. On top of that, healthier lifestyles and advances in medicine mean seniors are living longer and collecting benefits for many more years than was ever expected. The result is that there are far fewer workers supporting an ever-growing number of retirees. As the baby boomers begin to retire at the end of this decade, the worker-to-retiree ratio will look even worse.

Pay-As-You-Go

The current Social Security system is a pay-as-you-go system. It is not a savings or investment system but a simple transfer from workers to retirees. The payroll taxes from each generation of workers are not saved or invested for that generation's retirement; they are used to pay benefits for those already retired. The current generation of workers must then hope that when their retirement comes, the next generation of workers will pay the taxes to support their benefits, and so on.

Worker-to-Retiree Ratio Falling

When the ratio of workers to retirees falls, each worker must bear a greater financial burden. As a matter of simple math, this will raise the required tax rate: from around 2 percent in 1950, to 12.4 percent today, to around 18 percent in 2030.



Social Security Administration

The shrinking ratio of workers to retirees means that *in 2017, just 12 years from today, the Social Security system will begin to run a deficit.* In other words, it will begin to spend more on benefits than it brings in through taxes. And

Congress hasn't saved any money for that inevitability. Fewer workers per retiree means that each worker bears an increasing financial burden to pay the benefits that Social Security has promised. The original Social Security tax was just 2 percent on the first $3,000 that a worker earned, a maximum tax of $60 per year. By 1960 payroll taxes had risen to 6 percent.

Today's workers pay 12.4 percent. Half of that amount is taken directly from employees' wages, and the other half is referred to as the "employer portion." It's important to realize that the employer portion of the payroll tax is money that could otherwise be given to the worker as wages—the worth of an employee to her employer is actually the sum of her salary plus what the employer pays in payroll taxes.

The Ponzi Scheme

Why do some people call Social Security a Ponzi scheme? Charles Ponzi, an Italian immigrant, started the first such scheme in Boston in 1916. He convinced some people to let him invest their money, but he never made any real investments. He just took the money from later investors and gave it to the early investors, paying them a handsome profit on what they had originally paid in. He then used the early investors as advertisements to get still more investors, using their money to pay previous investors and so on.

To keep paying a profit to previous investors, Ponzi had to continue to find more and more new investors. Eventually, he couldn't expand the number of new investors fast enough, and the system collapsed. Because he never made any real investments, he had no money to pay back the newest investors. They lost all the money they "invested" with Ponzi. Ponzi was convicted of fraud and sent to prison.

Like Ponzi's plan, Social Security does not make any real investments. It just takes money from later investors (workers) and gives it to earlier investors (retirees). Like Ponzi, Social Security will eventually not be able to recruit new "investors" fast enough to continue paying promised benefits to previous investors. Because each year there are fewer workers for every retiree, Social Security will eventually collapse—just like Ponzi's scheme.

To continue funding retiree benefits, the payroll tax would have to be raised to about 18 percent by 2030. That's nearly a 50 percent increase. To look at it another way, Social Security taxes are one-eighth of an average worker's total annual wages—one of every eight dollars he or she earns. It is the biggest tax the average household must pay. Roughly 80 percent of American families pay more in Social Security taxes than they do in federal income taxes. Despite that already huge tax burden, the payroll tax will have to rise by nearly half if promised benefits are to be paid.

Why the Trust Fund Won't Help

What about the Social Security Trust Fund? Some people say that Social Security's financial problems are not that bad. You might hear the claim that Social Security has set aside enough money in the trust fund to pay benefits until 2041, the official date when the trust fund is projected to run out of money. Supporters of the current system often use that date to make the Social Security crisis seem far away. People who use that date either misunderstand how the trust fund works or, worse, are deliberately misleading you.

When the government collects payroll taxes, most of those taxes are immediately used to pay the benefits of current retirees. Right now, the gov-

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ernment collects more in taxes than it needs to pay in retiree benefits. The payroll tax dollars that aren't used for benefits constitute the surplus. The government takes the surplus money and writes an IOU to the Social Security Trust Fund.

Many people seem to harbor the impression that the money that gets collected through the payroll tax sits in a big vault waiting for them. On the contrary, by the time you retire, the money you've paid in has long since been spent on other government programs. The Social Security Trust Fund should actually be called the Social Security Filing Cabinet, in which the government IOUs are stored.

As you can see, the Social Security Trust Fund has no cash value. The IOUs in the filing cabinet aren't assets in the sense that they can be used to pay benefits. They are just claims against future tax dollars. Beginning in 2017, the government will have to pay back the IOUs in the trust fund, plus interest. Of course, since the government has no money with which to do so, it will have to either raise taxes or go deeper into debt in order to continue paying benefits. Those are exactly the same options that the government would face if there were no trust fund.

That is why most experts agree that Social Security's problems will begin with the payroll tax deficits in 2017, not when the trust fund "runs out" in 2041. To pay promised Social Security benefits, the government will have to raise taxes, cut benefits, or borrow more money.

What the Experts Say about the "Trust Fund"

These Trust Fund balances are available to finance future benefit payments . . . but only in a bookkeeping sense. . . . 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. The existence of Trust Fund balances, therefore, does not by itself have any impact on the government's ability to pay benefits.

—Clinton administration, FY2000 Budget

[The Trust Fund] has no real economic resources. . . . The key moments for Social Security are in 2018. Cash-flow benefits will equal cash-flow payroll taxes, and then after that, the Social Security Administration will have to come back to the rest of the budget for additional resources to pay promised benefits.

—Douglas Holtz-Eakin, director, Congressional Budget Office

Perhaps the biggest misperception is that the Social Security trust funds represent actual resources to be used for future benefit payments, rather than what is in reality a promise by the government to take the steps necessary to secure resources from the economy at that time. The accumulation of these securities in itself does not guarantee economic growth nor will it necessarily mitigate the problems associated with the rapid increase in Social Security's cost when the baby boom retires.

—Congressional Research Service

In effect, the general account is spending the OASDI surpluses to finance general account deficits. . . . In this situation, the trust fund more accurately represents a stack of IOUs to be presented to future generations for payments, rather than a buildup of resources to fund future benefits.

—Social Security Administration

More Problems with Social Security

As bad as Social Security's financial problems are, they are not the only problems facing the system. When we carefully analyze the current Social Security system and the way it delivers benefits, we discover that it can

- discriminate against working women and two-earner couples,
- deny benefits to many divorced individuals,
- work to the disadvantage of minorities and low-wage workers with shorter life expectancies, and
- increase the inequality of wealth over generations.

Given all those problems, on top of the financial problems facing the system, it's fair to ask, "Can't we do better?"

The Current System and Younger Americans

Ask younger Americans and they'll quickly tell you that they don't believe Social Security will be there for them. And they are right—at least in terms of what the system now promises. Younger Americans will receive lower returns than if they had invested in risk-free government bonds, and some younger workers are likely to see negative rates of return.

The cost of maintaining the current system through new taxes will fall disproportionately on today's younger workers. Keeping the system in balance will require a combination of tax hikes and benefit cuts that is likely to hit hardest those just starting out. *They will pay high taxes to ensure benefits for those currently at or near retirement and then see their own benefits fall when they retire.*

Low returns mean lower retirement incomes, less security, and greater poverty in retirement. For younger Americans, the current system is a very bad deal indeed.

The Current System Penalizes the Modern Family

Social Security was designed to meet the needs of two-parent single-earner families. In 1935 few women worked outside the home, few marriages ended in divorce, and few couples lived together without getting married. Today, the traditional family is increasingly less prevalent. Families have changed, but Social Security has not.

In a system of personal accounts, everyone would have his or her own retirement savings. Any work an individual performed would increase the account balance and raise benefits at retirement. Single workers and dual-earner couples would no longer be discriminated against. And cohabiting couples could designate one another as beneficiaries, an option that doesn't exist for unmarried people under the current system.

In addition, people who got divorced could be treated more fairly. To qualify for spousal benefits under the current Social Security system, a marriage must last 10 years. Today, however, marriages ending in divorce have a

The Dual Entitlement Rule

A spouse is entitled to his or her own benefits or benefits equal to one-half of those of the higher earning spouse—*but not both*. As a result, many women receive no additional benefits for the years of taxes they pay. They could have received just as much by not working and simply accepting the spousal benefit. T*he Dual Entitlement Rule is one of the most regressive aspects of the current system: a high-income single-earner couple receives greater returns from Social Security than a low-income single-worker or dual-earner family*.

median length of just 7 years; fully one-third of all marriages end before the 10 years needed for benefit eligibility. In a personal account system assets accumulated in a personal account during a marriage could be equitably divided, which is particularly important for women who might have worked less while raising families.

Social Security and African Americans

The current Social Security system is particularly unfair to African Americans:

Shorter Life Expectancies. At every age and every income level, African Americans have shorter life expectancies than whites. One-third of black men pay Social Security taxes but die before they collect a single penny in retirement benefits. Black men who do reach retirement age collect benefits for fewer years than their white counterparts. As a result, African Americans receive nearly $21,000 less from Social Security over their lifetimes than whites with identical incomes and family profiles.

Lower Incomes. Approximately 75 percent of African Americans receive most of their retirement income from Social Security, and 37 percent receive all of it from Social Security. That is double the percentage for whites. That means that most African Americans do not have other retirement options, such as 401(k)s and other savings, to rely on. The inability of Social Security to provide an adequate retirement income hits African Americans hard.

Spousal Benefits. In 2000 only 36 percent of black women were married (versus 57 percent of white women), meaning that most black women will be ineligible for spousal benefits at the time of their retirement.

Divorce. Nearly half of all marriages among African Americans end in divorce in less than 10 years. And a great number of African-American women do not remarry after divorce, further contributing to ineligibility for Social Security spousal benefits.

Disability. African Americans rely disproportionately on Social Security's disability protections. A well-structured personal account plan will protect disability benefits.

Social Security and Low-Income Households

Social Security was designed to be progressive. That is, low-income workers would receive higher benefits per dollar put in than higher-income workers.

In reality, however, Social Security does little to help low-income workers. Today, low-wage workers pay an eighth of their wages into Social Security all

their working lives and can still retire below the poverty line. In fact, nearly 15 percent of seniors are poor today, despite receiving Social Security. For widows, divorcées, or never-married women, poverty rates can approach 25 percent.

Moreover, although Social Security seems progressive, many economists now conclude that it is really not progressive at all. Why?

Simply put, the rich live longer than the poor, collecting benefits for more years. After all, if you live to age 100, you collect a lot of Social Security checks. If you die at age 67, it's not such a good deal. Even worse, Social Security benefits are not inheritable. Personal retirement accounts would allow workers who died before retirement to pass their Social Security benefits on to their survivors. In other words, they would have an inheritance, based on their years of hard work, to pass on. Under the current Social Security system, the money that would have been used for a worker's benefits simply goes back into the system if he dies prematurely—it can't be passed on to his wife or children. Personal retirement accounts would allow spouses, children, and the community to retain wealth and thereby reduce the wealth gap in low-income communities.

The Cato Plan

The failure of today's Social Security system stems from its pay-as-you-go structure, under which your payroll taxes are never saved or invested for your retirement. As a result, there have been several proposals to allow younger workers to privately invest a portion of their Social Security taxes through personal accounts.

Although President Bush has not yet laid out many specifics for a system of personal retirement accounts, the White House has provided some details about his vision for reform. In February 2005, the White House proposed that younger workers be allowed to privately invest 4 percent of their wages (about one-third of their Social Security taxes) through personal accounts, but with a maximum contribution of $1,000 in the first year. The maximum contribution would be very slowly increased each year until everyone was at 4 percent. Eligibility for accounts is phased in by age—those 40–55 can open accounts in the first year, 2009. Those 30-40 can enter in the second year, and all others the third year. Though financing the transition has not been discussed in specific terms, it is widely believed that President Bush favors borrowing most of the money.

Although the president should be applauded for being willing to address such a contentious issue, his proposal for reform doesn't go far enough in ensuring ownership, control, and inheritability. The Cato Institute has proposed a plan for reform that would allow workers to save and invest even more of their own money.

Under Cato's proposal:

- Individuals would be allowed to put their half (6.2 percentage

points) of the payroll tax into personal accounts.

- The remaining 6.2 percentage points of payroll taxes would be used to keep paying Social Security retirement benefits to those at or near retirement during the transition and to fund disability and survivors' benefits. Once the transition was complete, the employer payroll tax could be reduced to cover only survivors' and disability benefits.

- Workers choosing the personal account option would receive a "recognition bond" to reflect the benefits they have already earned under the current Social Security system. Those bonds, redeemable at retirement, would repay workers for what they have already paid into the system. Workers choosing personal accounts would not earn any future retirement benefits under the traditional Social Security system.

- Contributions to personal accounts would initially be placed in a limited number of broadly diversified investment funds. Eventually, once workers had accumulated funds and had more investment experience, they would be allowed to choose from a wider array of investment options if they wished.

- At retirement workers could choose either to purchase an annuity providing annual income equal to 100 percent of the poverty level or a programmed withdrawal option providing an equivalent level of income. Significant funds are likely to be available above this level and could be taken out as a lump sum, saved, left for loved ones, or used however the retiree chose. All monies in the account would be fully inheritable. Any money left in the worker's account at the time of his or her death could be passed on to a loved one.

- The federal government would provide a safety net ensuring that no worker's retirement income would fall below the poverty level.

- The accounts would be *voluntary*. Those who wished to remain in the traditional Social Security system would be free to do so, accepting the level of benefits that Social Security can currently pay. Those who stayed in Social Security would not be affected by those who chose individual accounts. Workers age 55 or older would not have their benefits changed in any way.

Proposed Legislation

Legislation based on Cato's plan has been introduced in Congress by Reps. Sam Johnson (R-TX) and Jeff Flake (R-AZ). According to the Social Security Administration, the Individual Social Security Investment Plan Act (H. R. 350) would return Social Security to permanent sustainable solvency.

Financing the Transition

Although moving to a system of personal accounts will save money in the long run, there will almost certainly be a short-term requirement for additional revenues. That is because, to the degree that workers choose personal accounts, payroll tax revenues will be redirected from the payment of current benefits to workers' personal retirement accounts. Because most of the workers expected to choose accounts are likely to be young, it will be many years before the accounts result in significant savings to the traditional system.

Therefore, Congress will be forced to find money in the short term to pay for the benefits of current retirees. Congress may have to borrow, sell government assets, or reduce other government spending. Although it would be worth it to borrow for personal retirement accounts, it would be far preferable to reduce federal spending.

In particular, Congress should cut corporate welfare and other pork-barrel spending. The Cato Institute has identified more than $87 billion each year in wasteful government subsidies to corporations. That money could be better spent on helping build an improved Social Security system.

A Better System

The Cato proposal would restore Social Security to long-term and sustainable solvency at a cost roughly half that of simply propping up the existing

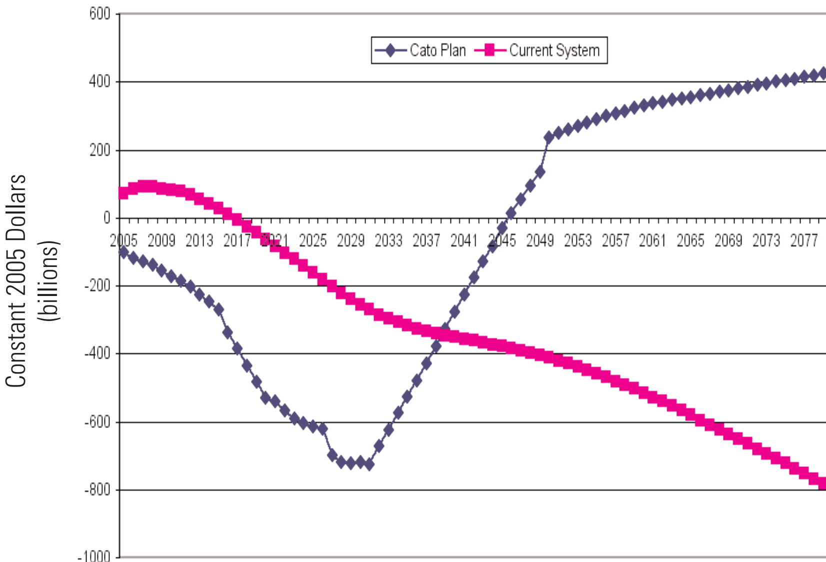
program. Although the plan would cost more up front, *over the life of the program it would save taxpayers nearly $6.3 trillion.*

But solvency shouldn't be the only goal. Younger workers who chose personal retirement accounts could receive substantially higher retirement funds than they would under traditional Social Security. At the same time, the personal accounts system would treat women and minorities more fairly and allow low-income workers to accumulate real wealth.

Most important, this proposal would give workers ownership of and control over their retirement income. It would prevent the government from spending workers' retirement money. It is a plan that is fiscally responsible and protects future generations of workers and taxpayers.

Of course, Cato's plan for Social Security reform is not the only plan being discussed. Other proposals vary in detail, but they would all allow workers to privately invest at least a portion of their taxes through personal accounts. Although we believe that our proposal offers the best approach to reforming Social Security and disagree with some of the proposals being offered by the president and others, we believe that all would offer a significant improvement over the current system.

Comparing Future Insolvency of Current System to SSA Projections under the Cato Plan



Social Security Administration

Frequently Asked Questions and Concerns

Is there really a Social Security crisis?

Some people say Social Security's financing problems are just a function of pessimistic economic projections. If the economy grows faster, they say, Social Security won't go broke. And so they then ask, "Why make big changes now for a problem that may never occur?" Unfortunately, that view is wrong.

Two independent panels of experts examined the trustees' projections of how our workforce and economy will grow. The panels found the trustees' estimates to be reasonable or maybe even a little optimistic regarding the future of the Social Security system's financing. In other words, instead of a "phony crisis," we might actually have something even worse than expected.

Social Security is safe today but will run deficits in just12 years. That's not a very long time to fix the world's biggest government program. Moreover, the longer we wait, the worse the problem will become. For every year that we wait, Social Security reform will cost an additional $600 billion.

Wouldn't moving to a system of personal accounts cost too much? I've heard the transition costs would be enormous.

The transition period is by far the most serious concern about a personal retirement account system. Under the current Social Security pay-as-you-go

system, all of the money going into Social Security is being spent on retirees' benefits and other government programs. How then can we put some Social Security money in private accounts and keep paying retirees' benefits? The short answer is that Social Security is already $12.8 trillion in debt. By switching to a personal retirement account system and taking advantage of compound asset growth we will be able to reduce that debt.

By switching to personally invested retirement accounts we can move some of those costs forward and *reduce Social Security's debt and bring the system back into solvency*. Tough decisions must be made about where to get the money to move those costs forward and pay them now so that we are not paying more later. While paying those costs now may seem expensive, it is much less expensive than continuing with the current system.

Think of your own credit card debts. Rather than making the minimum payments for the rest of your life, it would be much more fiscally responsible to pay them off today. And doing so would be much cheaper in the long run. Of course, it is not always easy to find the extra money to pay those bills today. Tough choices may have to be made.

That's what we are asking of Congress. We're asking it to make tough choices and pay the transition cost today, so that our children and grandchildren won't face much bigger debts tomorrow. Yes, we will have to do some belt tightening in order to fund personal accounts in the next several years while reducing Social Security's debt over the long haul. Tough decisions will have to be made about where to reduce federal spending. Cato has made some recommendations about where federal spending should be reduced, such as cutting pork-barrel spending and corporate welfare. Remember, because Social Security is already $12.8 trillion in debt, those tough choices will have to be made even if we don't switch to personal retirement accounts.

We will likely have to borrow at least some of the money for the short-term costs. Although it is better to reduce other spending than to borrow, it must be remembered that we will have to borrow even more if we don't fix Social Security now. Furthermore, borrowing to create personal accounts is different from borrowing for spending on benefits. There is a difference between borrowing for investment and borrowing for consunption, just like it is better to borrow to buy a house than to borrow to go on a vacation.

Further, we must not overlook the benefits to the economy that come from increased savings and investment.

Aren't personal accounts too risky?

Of course we all know that stocks can go down as well as up. But over the long term, investing is remarkably safe. Over the last 80 years, private investment in the United States has earned an average annual return of nearly 8 percent. That period included not only the market decline of the last few years but the Great Depression, World War II, several smaller wars, numerous recessions, the "stagflation" of the 1970s, and the bursting of the dot.com bubble. We need to remember that, with compound interest and stocks held over the working life of a typical U.S. worker, the money grows, even if the returns on that investment are lower in some years than in others.

Some people ask, "What if I had had a personal retirement account and had retired in 2002 when the tech bubble burst and the stock market lost so much money?" Good question. If you retired in 2002, most likely you would have been contributing to your personal retirement account for at least 25 years and probably longer. You may have started investing in 1978, when the Dow Jones Industrial Average was 742. At the low point of 2002, it was 7,286. Despite the crash, you would have received a far higher return than you would have seen from Social Security. The numbers are even more amazing for 40 years of investing. Retirement investments are long-term investments, and historically long-term investing in the American stock market is the best deal going.

In contrast, Social Security is becoming an increasingly bad deal for workers. We know that young workers can expect a return on their Social Security taxes of 1.5 percent or less. Furthermore, workers and retirees must keep in mind that Congress can change their benefits at any time, and probably will have to when the baby boomers retire. Thus workers and retirees must always consider the political risk of paying into the Social Security system when they have no legal right to benefits.

Beware of those who refer to Social Security as providing "guaranteed" benefits. Retirees have no legal right to benefits, and nothing prevents Congress from changing the benefit levels at any time. Thus the risk of being in the stock market must be weighed against the political risk of a program that provides no legal rights to participants.

Moreover, *there will still be a safety net*. Every personal retirement account proposal includes a safety net such that no one will fall below a certain level of retirement benefits. The Cato plan proposes a safety net so that no one will fall below the poverty line. That is a higher level than the current minimum benefit under Social Security.

And finally, keep in mind that personal retirement accounts are voluntary. If you are uncomfortable with the stock and bond market with all of its risks and you are more comfortable with the current Social Security system with all of its risks, you can always choose to stay in the current Social Security system.

Are there other ways to fix Social Security besides personal accounts?

Former president Bill Clinton laid out the very limited options for fixing the problem: raise taxes, cut benefits, or privately invest. Certainly, it is possible to raise taxes or cut benefits enough to prop up the existing system for a little while longer. But the Social Security payroll tax is already the biggest tax that the average American family pays. Do we really want our legacy to our children and grandchildren to be the largest tax increase in American history? Cutting benefits would be no better. Already, younger workers can expect a low, below-market return on their Social Security taxes. Benefit cuts would only make a bad deal worse.

Besides, raising taxes or cutting benefits would not do anything about Social Security's biggest problem: workers have no ownership of or control over their money. Only a system of personal accounts would give that ownership and control to workers.

What about raising the tax cap?

Workers currently pay Social Security taxes on the first $90,000 of their wages. Some people have suggested that the cap be raised or even eliminated altogether. The result would be the largest tax increase in U.S. history, $541 billion in new taxes over the first five years alone. That tax increase would fall primarily, not on the superrich, but on many upper-middle-class families and small businesses. Many experts believe that such an enormous tax increase would hurt the U.S. economy and cost millions of jobs. Even worse, it would do relatively little to fix Social Security. Studies show that removing the tax cap altogether would extend the solvency of Social Security by only seven years.

What about personal accounts in addition to Social Security?

There are two different types of personal accounts. Carve-out accounts would allow you to privately invest a portion of your current payroll taxes, "carving out" a portion of those taxes. Add-on accounts would require contributions over and above current payroll taxes. Some people have suggested

add-on accounts as a way to give people the advantages of private savings and investment, without changing the basic structure of Social Security. However, there are problems with add-on accounts. First, they do nothing to solve Social Security's financial problems. They would not change the program's pay-as-you-go structure or reduce Social Security's unfunded liabilities by a penny. Second, they would not give workers any more ownership of or control over their retirement funds. Finally, add-on accounts won't help those low- and middle-income families who, after paying 12.4 percent of their income into Social Security, simply would not be able to afford to put money into an add-on account.

Would personal accounts cut benefits?

Under any reasonable projections, personal accounts would actually provide higher benefits than Social Security can pay. It is important to remember that Social Security cannot pay all the benefits that it has promised. Unless there are huge tax increases in the future, Social Security will have to cut benefits by 26 percent.

If we move to personal accounts, will it hurt people on Social Security today?

No one age 55 or older will have his or her Social Security benefits changed in any way. Despite scare tactics by opponents of personal accounts, no one who is currently receiving Social Security benefits under the old system is going to have them taken away or reduced. This proposal is about making a better system for their children and grandchildren.

The trust fund will keep Social Security solvent for decades. What's the hurry?

The trust fund will keep Social Security solvent—on paper. But it cannot delay the need for tax increases or spending cuts by a day or reduce them by a dollar. The reason: the trust fund holds special-issue government bonds (really just IOUs), and when Social Security redeems them the government will have to raise taxes or cut other spending to produce the needed cash.

For example, in 2027 Social Security will run a payroll tax deficit of $200 billion (in today's dollars). If we didn't have a trust fund, we'd need to raise taxes or cut other spending by $200 billion. But we do have a trust fund. Yet to repay the fund's bonds, we still need to raise taxes, borrow, or cut other spending by $200 billion.

Besides, the person who will retire in 2041, the year the trust fund runs out, is a 31-year-old worker today. If we give young workers the choice of putting some of their taxes in personal accounts now, they will have the opportunity to begin accumulating money for their retirement. Those funds will mean that they will receive much better retirement benefits than Social Security would be able to pay them. Shame on us if we don't let younger workers begin saving and investing today and then when they retire shed a tear about their benefit cuts and say, "If only they had been allowed to invest privately back in 2005."

Would personal accounts "Enronize" Social Security?

In fact, personal accounts are nothing like Enron. Under the Cato plan, workers could invest only in diversified, approved mutual funds, not in single stocks or highly volatile stocks.

The current Social Security system is actually more like Enron:

- Like Enron, Social Security uses ambiguous "trust fund" type accounting that exaggerates its assets and hides its liabilities.
- Like Enron, Social Security gives workers little control over their savings.
- Like Enron, Social Security doesn't allow workers to diversify. Low-wage workers have nothing but Social Security.
- Like Enron, Social Security is going broke. Not as fast—but that won't matter to workers who are affected.

In the end, the Enron scandal revealed that people need more choice and more control over their retirement savings, including the option to invest part of their payroll taxes in personal retirement accounts.

Can ordinary workers invest wisely?

Many pundits argue that ordinary workers can't manage their own money. But millions of ordinary workers have already begun investing successfully through individual retirement accounts (IRAs) and 401(k) plans. Nearly every federal worker invests privately through the Thrift Savings Program. In fact, personal accounts would likely be modeled after the federal Thrift Savings Plan—simple, cheap, and easy to use. What the opposition is really saying is, "Low-income workers are too stupid to invest." That is patronizing, demeaning, and incorrect.

No one is suggesting that workers will have to sit down with a copy of the *Wall Street Journal* and try to choose between stock in General Motors and stock in General Electric. Under the Cato plan—and most other personal account plans—workers would be investing in broad-based, highly diversified funds, not choosing individual stocks.

People could choose from broad funds tailored to risk aversion. Someone who will rely on Social Security for the bulk of her retirement income, for example, could choose a more conservative mix of stocks and bonds. Those with significant investments and assets outside the Social Security system, on the other hand, might want to invest more aggressively. There will also be a default fund for those who don't want to choose. In those "life-cycle" funds, investments are shifted depending on age so that the investments become more conservative as the worker nears retirement.

Do Democrats support personal accounts?

In today's bitter partisan atmosphere, attitudes toward Social Security reform often get caught up in politics. But Social Security is far too important to rely on politics as usual. This issue concerns the future of our children and grandchildren, not whether or not you like President Bush.

Over the years, many prominent Democrats have supported personal accounts as part of Social Security reform. They include the late senator Daniel Patrick Moynihan, as well as former senators Bob Kerrey and Charles Robb and former congressmen Tim Penny and Charlie Stenholm. Even former president Bill Clinton had this to say about Social Security reform:

> If you don't like privatizing Social Security, and I don't like it very much, but you want to do something to try to increase the rate of return, what are your options? Well one thing you could do is to give people one or two percent of the payroll tax, with the same options that federal employees have with their retirement accounts; where you have three mutual funds that almost always perform as well or better than the market and a fourth option to buy government bonds, so you get the guaranteed Social Security return and a hundred percent safety just like you have with Social Security.

This should be an issue that unites all Americans regardless of party affiliation.

Does Congress pay Social Security taxes?

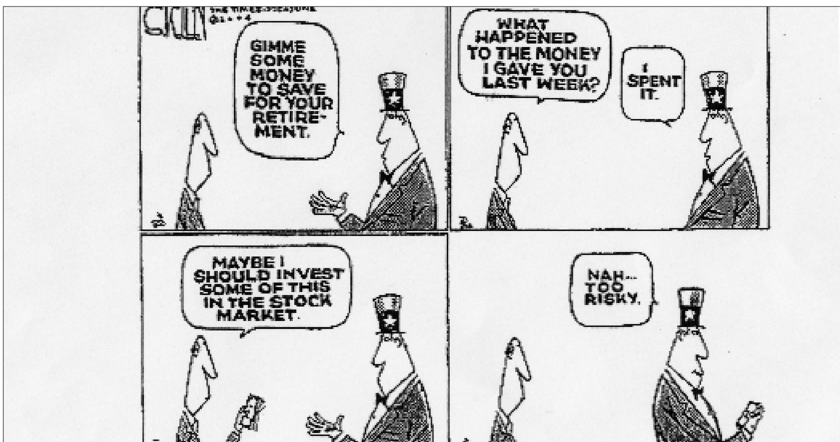
Many people have been misled by an Internet posting that says that representatives and senators do not pay Social Security taxes. Members of Congress do have very generous pension programs in addition to Social Security. But, since 1983, they have been part of the Social Security system and do pay Social Security taxes.

How can I learn more?

You can find out more information about Social Security reform at our website at www.socialsecurity.org. To find out more about the Cato Institute, visit www.cato.org.

What's the bottom line? Why should we have personal accounts as part of Social Security reform?

Social Security reform isn't just about keeping the program solvent. Of course, that's important. But if all we cared about was technical solvency, we could just raise taxes or cut benefits. Instead, we should see Social Security reform as an opportunity to build a new and better retirement program for all Americans. By giving younger workers the opportunity to save and invest a portion of their Social Security taxes through personal accounts, we can give workers ownership of and control over their retirement income. Young people, women, and minorities would be treated more fairly. Low- and middle-income workers should have the opportunity to build nest eggs of real, inheritable wealth. And, we can provide future retirees with better retirement benefits than Social Security would otherwise be able to pay. That's what true Social Security reform is really about—ownership, inheritability, and choice.



What You Can Do

Despite the advantages of personal retirement accounts, opposition to Social Security reform is strong. Powerful special interests are playing on the natural fear of change that many people have.

It is up to you to understand the fundamental issues involved so that your voice and your actions can influence this debate and promote the adoption of a national solution that can bring about a stronger and more secure retirement system.

As we have seen, there is a feasible, tested, and well-conceived plan to take our failing Social Security system into the 21st century. We should not view the need for change pessimistically. As a country, we now have a tremendous opportunity to change the largest government program in the world from an ineffective, outdated system into one that benefits individuals and our economy.

Doing nothing is simply not an option. Without action, benefits will be cut dramatically or taxes will be raised, or both. Every year that passes increases the cost of change by hundreds of billions of dollars. The sooner we act, the better.

Every member of Congress and every American citizen must become better educated about the Social Security debate. The impact of this fail-

ing program will affect our children, our grandchildren, our communities, and us. It is time to do the right thing and take the action necessary to make the Social Security system do what it was supposed to do. To do so, we must end a tradition of misinformation about what the system is and what it isn't.

Right now, it is a huge, unproductive tax burden. With individually owned personal accounts, it can be the source of security and wealth for all retirees—the original goal of the program. Further, and more important, ownership of our savings for the future can transform the way we think about retirement: we can stop thinking of it as dependence on the political process and start thinking of it as a time of dignity and satisfaction because we will be retiring on our own hard work and savings. Let's all work to make Social Security evolve so that we can keep the promises and meet the commitments of the original program.

Social Security reform will never happen unless you get involved. This is far too important an issue to leave to the politicians and the special interests in Washington. Let your voice be heard.

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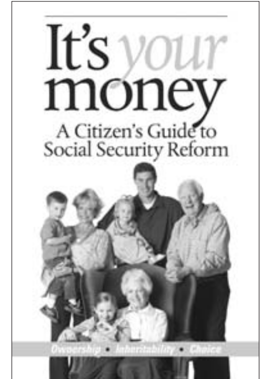

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Cato seeks to broaden the conversation about public policy by providing an alternative to partisan politics that is consistent with the traditional American principles of limited government, individual liberty, and peace. Toward that goal, we attempt to engage concerned and intelligent individuals in questions of policy and the proper role of government.

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