

SOCIAL SECURITY PROSPERITY



SOCIAL SECURITY IS STILL CONSIDERED untouchable by many politicians who think to go near it is political death. But the financial rewards for every American from Social Security reform and the creation of personal investment accounts are so great that Social Security reform should be a litmus test for your congressional vote. An average income couple in America, empowered to invest in personal accounts throughout their careers, each start out earning \$20,000 a year or less. By age forty, the husband is earning \$40,000 and the wife is earning \$30,000. At retirement they will accumulate \$829,800 if we create personal investment accounts—enough to pay them double what Social Security promises them, but cannot pay.¹

Given the rewards that personal investment accounts offer to working Americans, it is not surprising that for over a decade, polls have shown that a large majority support such an option.² A Zogby International poll found that 68 percent of respondents would support “changing the system to give younger workers the chance to invest a portion of their Social Security taxes through individual accounts similar to IRAs or 401(k)s.” Hispanics supported such an option by 72 percent, union households by 64 percent, and African Americans by 58 percent.

A 1999 *USA Today* poll found the public strongly opposed every major change to Social Security except one, a personal investment account option, which was favored by 66 percent of respondents. In 1997, Mark Penn conducted a poll for President Clinton that found that 73 percent of *Democrats* favored a personal account option for at least part of the program. These poll results have been borne out in recent elections. President Bush campaigned openly in 2000 on a personal account option for Social Security. He won while actually taking a majority of the senior vote in Florida. He campaigned even more aggressively on the idea in 2004, and won with an even bigger margin.

Leading Democratic opponents of personal accounts said the 2002 mid-term elections would be a referendum on such reform. Republican candidates who had supported the idea were bitterly attacked by the Democrats. The Democratic National Committee web site featured a cartoon video showing President Bush pushing seniors in wheelchairs off a cliff. Yet these Republican candidates won race after race, including many contested and high-profile races. Indeed, not one candidate seems to have been defeated on the issue. As political handicapper John Zogby reported after the election, "In every race where Social Security was a major issue, the pro-account candidate won."³

Now voices from the other side of the spectrum are beginning to turn towards such reform as well. At a December 3, 2002, Democratic Leadership Council Conference at New York University, former President Bill Clinton said the following:

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.⁴

Indeed, it has long since been forgotten that a plurality of the Social Security Advisory Committee that Clinton appointed in 1995 advocated a personal account option for Social Security that would allow workers to shift 5 percent of their payroll tax to the accounts. That should be the minimum for any new proposal.

In December 2002, the *Washington Post* followed Clinton's comments with an editorial that said the following:

It makes sense to consider the merits of a pension system in which at least a part of the money that ordinary workers pay into Social Security is invested in the private sector. The return on capital investment is higher, historically, than the growth in wage levels that support the payroll tax. Even in the 1930s, a privately invested system, had it existed, would have been able to distribute higher benefits than the present structure. It should not be taboo to discuss a system that might provide the poor, in particular, with higher benefits in old age, and that would encourage saving in a country that is notoriously bad at it.⁵

Even though there is strong, broad, public support for the idea of personal accounts, it does not mean enacting a personal account option into law will be easy. The Left has a simple, Manichean view of the world—government good, private markets bad—and they will fight against the idea with a religious fervor.

Furthermore, don't expect opponents to fight against the idea with any intellectual honesty. Vulnerable seniors will be frightened and milked for political donations with ridiculous claims that this or that candidate will take away their Social Security, their homes, and the food on their table. In the past, there were campaigns that sent workers into nursing homes to tell extremely frail residents that the Republican candidate would throw them out of the home and onto the snow if they did not sign an absentee ballot for the Democrat opponent.

THE BASIC STRUCTURE OF SOCIAL SECURITY

Social Security is the single largest federal program and bigger than the entire budget of most countries. For fiscal year 2005, the Social Security payroll tax is projected to raise \$575 billion, or 28 percent of total federal taxes for the year. Social Security expenditures are projected to be \$515 billion, or 21.5 percent of total federal spending.

We spend more on Social Security than on national defense, even in a time of war. National defense spending in 2005 is projected to be \$451 billion, 12 percent less than Social Security expenditures. For fiscal 2006, defense expenditures are projected to be 18 percent less than Social Security spending.

Social Security was enacted in 1935 as a central component of Franklin Roosevelt's New Deal. It was financed by a new payroll tax of 1 percent on both employer and employee, assessed on the first \$3,000 of wage income each year. This resulted in a maximum annual tax of \$60 for each worker, which stayed at that level until 1950, when it was raised to \$90. In return for the tax, the program paid benefits to retirees after they reached age sixty-five.

As early as the mid-1970s, actuaries began predicting that tax revenues would eventually be insufficient to pay promised benefits. Congress responded in 1977 by passing amendments designed to “fix” the problem. President Jimmy Carter proclaimed that they would ensure the solvency of Social Security “for the rest of this century and well into the next one.” But just a few years later, in 1981, the program’s actuaries were back again projecting that the program would run short of funds within a few years.

President Reagan’s budget director David Stockman developed a plan to close the gap for a while by reducing the rate of growth of Social Security benefits. Before the administration could even formally propose the plan, the Senate voted 96–0 on a resolution asking the president not to even send the proposals to Capitol Hill. This led to the formation of a bipartisan commission chaired by Federal Reserve chairman Alan Greenspan.

Through the commission, the administration negotiated a final package that for the first time relied more on restraining benefits than on raising taxes. The 1983 amendments kept Social Security paying the bills, but the actuaries continued to project an enormous, never-ending financial gap. The latest annual report of the Social Security Board of Trustees projects that Social Security will run short of funds to pay promised benefits in 2042.⁶ Workers born in 1975 can expect to be retiring that year.

There is one basic feature in the structure of Social Security that is central to all of its problems and key to understanding the real solution: Social Security operates on a pay-as-you-go basis. This means the taxes of today’s workers are not saved and invested to finance their future benefits but are paid out to finance the benefits of today’s retirees. The future benefits of today’s workers will be paid out of the

future taxes of those who are working at the time. Social Security as structured today is a redistribution system, not a savings and investment system.

Even the current short-term annual surpluses are not saved and invested. Those funds are lent to the federal government in return for IOUs held in the Social Security Trust Fund. The government then spends that money on everything from welfare to State Department embassies. For example, about 90 percent of the current Social Security tax revenues of \$575 billion will be spent this year on Social Security benefits of \$515 billion. This means \$60 billion will be lent to the federal government for more Social Security Trust Fund IOUs and spent on the rest of the federal government's \$2.4 trillion budget.

SOCIAL SECURITY'S LONG-TERM FINANCING CRISIS

A poll in the early 1990s found that more than twice as many young adults believed in UFOs as believed Social Security would still exist by the time they retire. Those young adults were on to something. Continuing to pay all promised benefits would require a massive rise in the total payroll tax rate from 12.4 percent today to about 18 percent—a 50 percent increase.⁷ Moreover, the tax would have to be raised every year thereafter as the cost of full benefits as a percent of taxable payroll continues on a permanent climb. The projection stops in 2080 when the payroll tax rate would have to be close to 20 percent to pay all promised benefits. Then the increase would have to continue indefinitely after this as well.

In fact, the true financial crisis starts much sooner than 2042. In year 2018, the system will begin to run a deficit. In order to keep pay-

ing benefits, the trust fund will have to start turning in the IOUs it has been accumulating to get extra cash from the federal government. To get that cash, the government will have to raise taxes, cut other spending, or increase its deficits and borrow. From 2018 until the trust funds run out in 2042, the federal government will have to come up with an additional \$8 trillion in today's dollars for Social Security in order to keep paying all promised benefits during that period. That is a huge financial crisis, starting just thirteen years from now.

If Social Security were a fully funded savings and investment system, then enough reserve assets would be on hand to pay all the future benefits that had been earned at any point.⁸ By contrast, in the current pay-as-you-go system, we must continue to bring new workers into the economy and tax them at higher and higher levels in order to fund the growing number of retirees.

Most people know that the large baby boom population is one reason for the potential crisis. Birth rates soared soon after the soldiers returned home from World War II and remained at a high level until the early 1960s. Those born during this period will begin retiring in hordes less than ten years from now, causing Social Security benefit obligations to soar.

But that's only half the story. The baby boom was followed by a baby bust. The development of the birth control pill, the legalization of abortion, and changing social attitudes led to a sharp decline of birth rates starting in the early 1960s. This occurred not only in the United States, but in all Western countries, much more so, in fact, in Western Europe.

The U.S. fertility rate declined from 3.8 in 1957, to 2.43 in 1970, to 1.77 in 1975.⁹ The fertility rate needs to be at least 2.1 to maintain a stable indigenous population. But the U.S. rate stayed well below this

level until 1990, when it climbed back up, around 2.1, where it has stayed since that time.

What this means is that just as the baby boom generation retires, the generation of workers behind them will be experiencing much slower growth. This is a disaster for a pay-as-you-go system like Social Security. Just when benefit obligations will be soaring due to the retirement of the baby boom generation, the growth of taxes paid by the baby bust generation of workers behind them will be slowing down. Population increases due to immigration make America better off than Europe or Japan, but nonetheless there will be considerable financial pressure on the children and grandchildren of the baby boomers if we stay with the current static model of income transfers between generations.

Another major factor causing the long term Social Security financing crisis is increasing life expectancy. The baby boom generation is not only large, but it is expected to live much longer than previous generations, resulting in greater benefit obligations for Social Security.

In 1940, when Social Security was starting, life expectancy was 61.4 years for men and 65.7 for women.¹⁰ Social Security's promise to pay full benefits, starting at age 65, was actually a promise to pay those benefits to less than half the population.

But today, life expectancy is about 74.4 for men and 79.5 for women.¹¹ By the time those entering the work force today start retiring, Social Security's actuaries project that life expectancy will have increased to 79.2 for men and 83.3 for women.¹² And that projection is based on a decline in the rate of increase in life expectancy we have experienced since 1940. More likely, with the high-tech medicines of the twenty-first century, life expectancy will increase faster, not slower, than in the last half of the twentieth century.

These are the reasons why the number of workers paying taxes to Social Security has declined from 4.2 in 1945 to 3.3 today per retiree.¹³ It is projected to fall to 2.0 workers per retiree by 2040.¹⁴ The prospect of longer lives for Americans would turn from a great joy to a great burden and could even lead to intergenerational bitterness.

Consider Europe's present pension crisis. Virtually every European government will continue to face huge budget deficits as the number of people receiving retirement pensions increases while the number of people still working and paying taxes stagnates and declines. Reforming Social Security with personal accounts would save us from a similar fate.

WE CAN DO BETTER

But there is an even bigger problem for Social Security than its long-term financing crisis. The program is no longer a good deal for working people today. Even if the program could pay all its promised benefits, the benefits would still represent a low, below-market return on the huge taxes workers and their employers now pay into the program. If today's workers could save and invest instead in their own personal accounts, they would likely receive far higher returns and benefits than Social Security now promises them, let alone what it can pay. With a long investment time frame, the risk of investing in the financial markets is significantly reduced.

The long-term real rate of return on corporate stocks is at least 7.0 to 7.5 percent.¹⁵ In fact, going all the way back to 1926, when the most reliable data starts, the real rate of return on large company stocks listed on the New York Stock Exchange has been 7.5 percent.¹⁶ The

real return on smaller company stocks on the Exchange has been even higher, at 9.2 percent.¹⁷ This period covers the Great Depression, World War II, more intermediate-size wars, the turbulent inflation/recession years of the 1970s, and the recent high-tech bubble collapse. The long term real return on corporate bonds has been around 3.5 percent.¹⁸ At these rates, a portfolio of half stocks and half bonds over a worker's career would earn a net annual real return of 5 percent. A portfolio of two-thirds stocks and one-third bonds over a working career would earn a net real return of 5.75 percent.¹⁹

By contrast, Peter Ferrara and Michael Tanner, in a Cato Institute study, calculated that for most workers—middle aged and younger—the real rate of return on the taxes they and their employers pay into Social Security would be 1 to 1.5 percent or less.²⁰ For many it would be zero or negative.

One example in the Ferrara and Tanner study calculated the real rate of return promised by Social Security for a two-earner average income couple. The husband earned the average income for males each year and the wife earned the average income for females. Again, assume Social Security somehow is able to pay all of its promised benefits. The real rate of return this couple would receive on the taxes paid by them and their employers would be less than 1 percent—0.78 percent. For an average-income single worker, the real return would be even less, 0.31 percent. A widely noted Heritage Foundation study²¹ found quite similar results, as have others.

But the outlook is even worse, since we know that Social Security will not be able to magically pay all of its promised benefits. Under the current system, either taxes will have to be increased by more than 50 percent, or benefits will have to be cut by 40 percent or more, or some combination of the two. This would dramatically lower the returns dis-

cussed above. Most workers would then expect a zero or even negative real rate of return. In other words, instead of getting a return on your savings, you are currently transferring your savings as taxes for a payout that may be less in benefits than what you and your employers paid in over your career—a negative rate of return. No one would find that acceptable when investing in the stock or bond market.

This large difference in returns adds up to an enormous difference in accumulated assets and benefits over a lifetime of work, investment, and retirement. Take the case of an average two-income couple noted at the outset. Suppose they could invest in a personal account over their entire careers equivalent to the account proposed in the Ryan–Sununu bill discussed later in this chapter. With two-thirds invested in stocks and one-third invested in bonds, and earning standard market returns, they would reach retirement with almost \$1 million in today’s dollars. That would be enough to pay them twice what Social Security promises but cannot pay.²²

Why this enormous gulf between the payouts of personal accounts and Social Security? Unlike Social Security, the personal accounts operate as a fully funded savings and investment system. The money paid in is saved and invested in America’s companies through the financial markets. These capital investments increase production, which provides more resources to pay workers higher benefits.

AFRICAN AMERICANS GET THE WORST DEAL IN SOCIAL SECURITY

The poor deal offered by Social Security applies with a vengeance to African Americans because they have much shorter life expectancies

than the general population. Consequently, they have fewer retirement years to collect benefits. A black male born today has a life expectancy of 65.8 years, while the Social Security retirement age by the time he retires is age sixty-seven.²³ This means African Americans on average receive even lower returns on the taxes they pay into the system. The Heritage Foundation study calculated that a single black male born in 1970 could expect a real return from Social Security of -1.5 percent, even if all promised Social Security benefits were somehow paid.²⁴ The return for an average-income two-earner family with children is effectively 0 percent.²⁵

With personal accounts, workers who die before retirement or just after retirement would be able to leave the funds to their children or other heirs. Moreover, social organizations like the National Association for the Advancement of Colored People (NAACP) could offer annuities promising a monthly benefit for life focused exclusively on their African American membership. Those annuities could then take into account the lower life expectancies of African Americans and pay higher retirement benefits. If one group has the most to gain from personal social security accounts, it is African Americans.

HISPANICS AND SOCIAL SECURITY

Hispanics also suffer from a special problem under Social Security. The Hispanic population is much younger than the general population, and since the return paid by Social Security is falling over time, younger populations get lower returns on average than others. Only 5 percent of Hispanic Americans are over sixty-five, compared to

12 percent of the general population.²⁶ Moreover, only about 30 percent of Hispanic Americans over sixty-five receive any retirement income from assets, compared to 68 percent of the general population.²⁷ Clearly, Hispanic Americans are among those who would also have a lot to gain from a personal account option for Social Security.

MARRIED WORKING WOMEN AND SOCIAL SECURITY

Working women would get a much better deal with personal accounts. A working woman is entitled to retirement and survivor benefits under Social Security based on the taxes her husband and his employers paid. If she works, she gets the benefits only if they are higher than her own projected Social Security benefits. She gets no additional benefits for all her years working and paying into the system. If, however, her own Social Security retirement benefits are higher than her husband's record, then she gets those benefits but loses the benefits she would otherwise be entitled to from her husband. With personal accounts, by contrast, both husband and wife retain control over all the investments and savings they have paid.

SOCIAL SECURITY AND THE ECONOMY

About thirty years ago, Harvard economics professor Martin Feldstein, chairman of the National Bureau of Economic Research, began writing about the effects of the rapidly growing Social Security system on the economy. His conclusion was that Social Security was becoming a major drag on the economy.

Feldstein found that because workers assume Social Security will pay for their retirement, they don't save for it, or sharply reduce what they would otherwise save. Since Social Security operates as a pay-as-you-go system, with no real savings, the result is a net loss of actual savings and investment. With the Social Security taxes that finance retirement benefits currently running at about \$575 billion a year, or about one-fourth of total annual private savings, the net loss is huge.

Feldstein buttressed his analysis with substantial econometric work concluding that Social Security reduces national saving by 40 percent or more. Studies by others have varied from finding similar results to results only about half as large. But even at the lower estimates, the loss of savings and investment would reduce America's gross domestic product (GDP) by about 5 percent each year. At Feldstein's original estimates the loss of GDP would be about 10 percent a year. With GDP currently running about \$11 trillion a year, we are talking about losses in the range of \$500 billion to a trillion dollars a year.

But there is still more. The payroll tax sharply reduces the net wages workers receive for working. The loss of savings and investment means lower productivity and so less wages as well. This reduces the labor supply and causes other distortions in the labor markets. Feldstein estimates that the result is another loss of GDP of 1 percent a year.²⁸

Modernizing Social Security through personal accounts would raise take-home pay and free workers to put hundreds of billions and ultimately trillions of dollars in savings and investment; that would be a huge benefit to our economy. The accounts indeed represent a new, very large tax-free shelter for saving and investment. It would be the equal of a capital gains tax cut to further stimulate the economy. All of this adds up to a dramatic increase in savings and investment—and an economic boom.²⁹

THE RYAN–SUNUNU BILL

Is all this a pipe dream? Something that can never happen politically?
No.

Last summer, Representative Paul Ryan and Senator John Sununu introduced a bill in the House and the Senate that provides for a personal account option for Social Security and solves the long-term problems of the program. The bill offers one of the most sweeping, fundamental reforms in our nation's history. For the major components of the bill, visit www.newt.org/winningthefuture.³⁰

The bill has been officially scored by the chief actuary of Social Security to determine its impact on Social Security and federal finances.³¹ The chief actuary reported that under the reform plan, “the Social Security program would be expected to be solvent and to meet its benefit obligations throughout the long-range period 2003 through 2077 and beyond.”³² The reform eliminates completely the unfunded liability of Social Security, currently officially estimated at \$11 trillion. This is effectively the largest reduction in government debt in world history. Moreover, the Ryan–Sununu reform plan would actually cut taxes and increase benefits over time.

The reform plan starts producing surpluses by 2030. Those surpluses are first devoted to paying off the debt issued in the earlier years of the reform. After that is completed by about 2045, the surpluses go to reducing payroll taxes under an automatic payroll tax cut trigger specifically included in the bill. Under the chief actuary's score, the surpluses would be sufficient to reduce the total payroll tax eventually to about 4 percent, 2 percent each for employer and employee. Workers and employers would still contribute a total of 6.4 percent in addition for the accounts. But this is money that belongs to the workers

in their own individual accounts, so it is not a tax that goes to the government. And remember that this is an alternative to raising the current 12.4 percent total payroll tax to 20 percent, as would be required to pay all benefits promised under the current law. *The Ryan–Sununu plan would be effectively the largest tax cut in world history.*

The reform would also greatly broaden the ownership of wealth and capital through the accounts. Under the chief actuary's score, workers would accumulate \$7 trillion in today's dollars within the first fifteen years, by 2020. This huge, breakthrough gain in the prosperity of working people would have broad implications throughout our society.

Many more people would have an ownership stake in America's businesses. Support for free market policies would be shared more generally throughout our society. That would translate into more rapid economic growth and more prosperity for everyone, with no tax on the returns to the accounts, no tax on the benefits paid from the accounts, and no estate tax when account funds are left to children or other heirs.

The full potential economic gain from such reform has not been fully appreciated. All of the high-tech advances that beckon in the twenty-first century will require huge amounts of capital to achieve full practical application. The Ryan-Sununu reform will help provide the capital for a sweeping technology revolution that in turn will make returns on personal accounts potentially higher than we can predict using older models of economic growth.

Democrats argue against personal accounts by saying that workers should not be fooled into trading a guaranteed benefit (by which they mean the current Social Security benefits, which, in fact, are not guaranteed), for a speculative one (by which they mean personal account benefits). But the Ryan–Sununu plan does not involve any such trade-

off. The legislation includes a federal guarantee that those with personal accounts would get at least as much as promised by Social Security today (which, again, the current system cannot pay, according to official government projections).

The cost of this guarantee was scored by the chief actuary of Social Security and is fully paid for under the reform plan. The guarantee works because capital market investment returns are so much higher than what Social Security promises; let alone what it can pay. Indeed, with workers choosing investments only from a list of fully diversified portfolios managed by top professional companies approved and regulated by the government, Peter Ferrara argues that even the chief actuary's estimated cost is surely excessive.

THE CHALLENGE OF HISTORIC REFORM

For conservatives, such personal account reform could not be a bigger or more urgent issue. By shifting fundamentally all Social Security retirement benefits to the personal accounts over the long run, and financing part of the transition by reducing the rate of growth of federal spending, the Ryan–Sununu bill will ultimately reduce federal spending by roughly 6.5 percent of GDP. That, in fact, is a must if we are to avoid an explosion of federal spending relative to GDP that will result under current federal policies.

Personal accounts will in fact fulfill the promise that the Social Security system cannot deliver: a guaranteed retirement account. President Franklin Roosevelt and President Ronald Reagan would both be pleased.

For more information on Social Security personal accounts,
visit www.newt.org/winningthefuture