

SOCIAL SECURITY REFORM: PRIVATE ACCOUNTS, NO TAX HIKES, SPENDING CUTS

By any fiscal measure, the U.S. faces a demography-driven crisis of entitlements spending. The aging of the population, resulting in a larger proportion of people being elderly, and larger proportion of the elderly living longer, will inflate the costs of both Medicare and Social Security. This financial tsunami represents unfunded liabilities of more than \$100 trillion. Medicare is in by far the worst shape, but the Social Security shortfall is daunting enough: \$15.8 trillion. (Also commonly used are the shortfalls over a 75-year, rather than infinite, time horizon—\$42.9 and \$6.6 trillion, respectively).ⁱ

The longer we wait to address the problem, the bigger will be the shortfall. For instance, the lower-bound deficit grew by \$2 trillion and the upper bound by *\$11.5 trillion* from just 2007 to 2008.ⁱⁱ Adjusting retirement benefits is easiest before people retire, when they still have an opportunity to adjust their work and saving habits. Now that the Baby Boomers have begun to retire, it becomes much more difficult to reform the system.

The U.S. already is living on the edge financially. The national debt is \$9.5 trillion and going up (the debt ceiling was raised recently to \$10.6 trillion). The deficit next year (2009) is now budgeted at nearly a half trillion dollars, but is likely to run higher. The list of potential federal obligations is long; and including, among others: government employee retirement benefits, making good on private pension guarantees, and bailing out any number of improvident and insolvent financial actors. For instance, Fannie Mae and Freddie Mac have accumulated as much as \$1 trillion in bad mortgages, with less than a tenth of that amount set aside in bad debt reserves. Add to all of them the entitlements liabilities -- if the programs continue on their present course, federal retirement benefits, primarily Social Security and Medicare, alone will go from nine to 21 percent of national income between 2005 and 2050.ⁱⁱⁱ

Creating Social Security

Social Security was created in 1935, in the midst of the “Great Depression,” to provide a retirement safety net for American workers. Sold as social insurance, the program actually mixes welfare and earned benefits. Although workers nominally have personal accounts—and can find out how much they are entitled to collect as a result of their earnings—their benefits are neither legally guaranteed nor set aside in an account that earns money. Moreover, while there is formally a “trust fund,” it is a fiction, a book-keeping entry for tax monies collected through the payroll tax and lent to the Treasury to be spent elsewhere. The result is a file cabinet full of bonds rather than a vault full of cash. Indeed, the well-promoted image of Social Security as a system of social insurance in which people merely get back what they put in is a not-so-noble lie, “based on a self-conscious program of manipulation designed to obscure the nature of the program and create a sense of entitlement that makes the program extremely difficult to change,” explained analyst Will Wilkinson.^{iv}

In practice, the system is “pay-as-you-go,” which, if it was a private system, would be characterized as a Ponzi scheme; that is, a variant of Charles Ponzi’s famous swindle in 1920 in which he promised fantastic rates of return and paid off early investors with the contributions of later investors. The scam collapsed within a year because Mr. Ponzi lacked the federal government’s power to tax ever more and to force more and more workers into the program.^v

Nevertheless, the system appeared to work well for many years, because a large number of employees (literally dozens near the start) supported every retiree and many of those workers (almost half) died before collecting their first check. It was an almost perfect political program: politicians were able to promise future benefits financed by relatively low taxes, and then didn’t have to make good on their promises to many potential recipients. Those who did live long enough to receive Social Security were happy, since they enjoyed a very good deal, often receiving back the equivalent of their contributions (including the taxes paid directly by their employers) within a couple of years.

Changing demographics mixed with irresponsible political cupidity however, has transformed the program. The retiree to worker ratio has steadily fallen. It was roughly 16-to-1 in 1950. It is about 3.3 today, will be 2.6 in 2020, and eventually will hit 1.9.^{vi} The damage to the system’s fiscal solvency could have been contained by reducing benefits, but one Congress after another and presidents of both major parties moved in the opposite direction. For instance, Richard Nixon won approval for an election year benefit hike of 25 percent hike in 1972. As the number of workers fell while benefits rose, so did the taxes needed to keep the program solvent. That, in turn, caused the rates of return for beneficiaries to fall dramatically. Fears of an impending crisis led to a commission and bipartisan rescue weighted towards tax

hikes in 1983. But it proved to be but a temporary palliative, since it did nothing to resolve the system's underlying structural flaws. An ever more serious crisis is looming over us today.

Impending Fiscal Collapse

First, the system is heading towards fiscal collapse, as the nation's roughly 80 million baby-boomers, born between 1946 and 1964, retire. The wave has started this year, with the option to retire at age 62. There are many ways to analyze Social Security's fiscal future, and the result often is confusing. One simple measure is the system's share of GDP. In 2006 Social Security accounted for 4.2 percent of GDP. In 2040 it is expected to consume 6.6 percent of GDP. (In contrast, Medicare begins behind Social Security and races ahead of it over the same time period.)^{vii} Another way -- even more sobering -- of looking at the issue is that Social Security and Medicare will consume the entire federal budget by 2040 if current trends continue.^{viii} Income tax rates would have to escalate to 25, 63, and 88 percent, from the current 10, 25, and 35 percent, in order to cover the dual shortfall.^{ix} Otherwise, Americans can pray that the economy grows at double digit rates for the next 75 years, helping to forestall financial catastrophe.^x

In the most simple analysis, to make Social Security's numbers work in 2040 would require either doubling taxes or halving benefits. Neither is an appealing option.

Program defenders cite the Social Security "trust fund," which nominally contains \$2.2 trillion (in net present value), about one-third of the 75-year Social Security shortfall. *In theory*, the Social Security System will collect more money than it pays out until 2017, and then will be able to rely on its accumulated surplus until 2041.^{xi} However, as noted earlier, the trust fund's money already has been spent.^{xiii} Simply put, when the system goes negative in 2017, Social Security will be out of money. Making up the shortfall will require either more taxes or less spending, notwithstanding the fact that the Social Security System possesses a file cabinet full of paper IOUs from the Department of the Treasury.

If Congress does not put these programs on a responsible financial footing, the problems will cascade. Earlier this year Moody's Investors Services announced it was considering downgrading federal bonds because of the government's failure to fund its entitlements programs. "These two programs are the largest threats to the long-term financial health of the United States and to the governments' AAA rating," Moody's Vice President Steven Hess announced. Tom Lemmon of Moody's said the company acted "because the underlying credit rating of the U.S. government faces the risk of downgrading in the next ten years if solutions are not found to our growing

Medicare and Social Security unfunded obligations.”^{xiii} Such a downgrading would force the Treasury to pay higher interest costs, hiking federal outlays even more.

This would make it even harder to continuing financing current consumption through deficit spending. In May 2008 the Congressional Budget Office warned: “Budget deficits that grow faster than the economy ultimately become unsustainable. As the government attempts to finance its interest payments by issuing more debt, the rise in deficits accelerates. That, in turn, leads to a vicious circle in which the government issues ever-larger amounts of debt in order to pay ever-higher interest charges. In the end, the costs of servicing the debt outstrip the economic resources available for financing those expenditures. At some point, then, policy has to change: Taxes must be raised, spending must be reduced, or both.”^{xiv}

Inadequate Financial Returns

It is also important to recognize that beneficiaries are receiving far less than they would earn in a private system. The most important difference between Social Security and private annuities is that recipients have no property interest in the former system. That is, under Social Security, there is no legally-guaranteed payment. Recipients do not own the principal (even though it is their own money that created it), with the ability to dip into it early or pass it on to their heirs.

Another Social Security anomaly is the arbitrariness of returns. African-Americans and men average shorter life-spans than whites and women, respectively, and thus receive less money in Social Security benefits (if they owned the principal, this difference wouldn’t much matter).^{xv} Single men do worse than single women, who do worse than two-earner couples, who do worse than one-earner couples.^{xvi} A marriage must last for ten years before a divorced spouse is eligible for any benefits. Market annuities, in contrast, are no respecter of irrelevant demographic and family differences.

Moreover, the “rate of return” (ROR) -- counting Social Security taxes as an investment -- has been steadily falling. (The employer’s share effectively comes out of the employee’s paycheck, so the *combined* total really is the employee’s contribution.) In the early years beneficiaries enjoyed a very good deal indeed. The combined employer-employee tax started out at just two percent up to \$3000 of income. Ida May Fuller, Social Security’s first recipient, paid only \$44 in Social Security taxes over three years before retiring in 1940, and collecting \$20,933.52 before she died in 1975 (at age 100).^{xvii} Obviously, not every early recipient did that well, but for many years the system provided benefits way out of proportion to taxes paid.

However, those times are long over. Rates vary depending upon income and marital status, but the ROR has been falling across the board. The ROR for a worker

who retired in the 1970s ranged between 5.4 percent and 10.7 percent. The rate for a worker now in his or her mid-30s runs between .6 and 4.6 percent. For a newborn, assuming the system survives, the ROR will come in between .2 and 4.0 percent.^{xxviii} The Social Security System does its own analysis of an estimated internal real rate of return, and that figure has been falling steadily over time. Five years ago most low- to medium-income beneficiaries, other than one-earner couples, were receiving less than two percent, while most higher earners were below one percent or even negative.^{xix} Other estimates for a steady-state return from Social Security in the future tend towards 1 percent to 1.5 percent.^{xx} Larry Lindsey of the American Enterprise Institute figures that an average “high-wage” worker today, making \$67,000 annually, will actually receive back about \$35,000 less than the taxes he or she paid in.^{xxi}

It also must be kept in mind that these benefit estimates should be discounted to account for the political risks of Social Security. The system cannot survive unchanged, and any hike in tax rates or drop in benefits will push down the ROR.

Private investments also do not guarantee any specific return, of course, but the principal does not dissipate upon the investor’s death. Moreover, in the private-investment arena, average annual returns have been stable over time—roughly 7 percent for stocks, 4 percent for bonds, and 5.5 percent for a mixed portfolio.^{xxii} Other estimates for private investments range up to nine percent.^{xxiii} (It should be noted that these estimates are all after-tax. Pre-tax RORs are substantially higher.^{xxiv}) The ROR for private investment has remained well above the levels for Social Security even when measured cashing out after major stock market downturns, as in 1987.^{xxv} The ROR was over three percent annually for even the worst 20-year period in American history, encompassing the Great Depression.^{xxvi}

Even small differences in ROR generate significant differences in income. For a hypothetical Social Security recipient, escaping the system and moving from a one to a four percent ROR results in an extra \$11,000 annually, and \$166,000 more in principal. At a seven percent ROR, the increase is \$41,000 and \$626,000, respectively.^{xxvii}

Even these numbers understate the advantage of private investment, since Social Security’s nominal rate of return needs to be discounted by its negative impact on the economy. The program both reduces the amount of money available for workers to save as well as their incentive to save. By reducing the resources available for economic investment, Social Security reduces both GDP and real wages in future years. Estimates of that loss range from five to ten percent. Integrating that impact into current rates of return suggests that the average retiree has lost money and receives a long-term ROR of *minus* 1.1 percent.^{xxviii}

Inadequate Washington Alternatives

Three main options are favored by the Brainiacs in Washington. One is to do nothing. Although that might work for today, it promises disaster in coming decades. Three years ago economist Jagadeesh Gokhale explained: “The program’s massive financial shortfall implies an annual interest cost accrual of more than \$700 billion—far exceeding growth in the economy’s capacity. If changes to Social Security policies are delayed, runaway growth in Social Security’s financial shortfall is likely to ensure higher tax rates and more adverse reactions by financial markets in the future.”^{xxxix}

Indeed, to do nothing is to invite generational conflict, as the Baby Boomer generation leads older cohorts in the battle to sacrifice everything else, by cutting other programs and hiking taxes in order to “save” Social Security. Those facing higher payroll levies and lost jobs, concentrated in younger cohorts, would represent the other side. The fight is likely to be protracted and costly—and seems inevitable without systematic reform as soon as possible. The longer we wait to address the problem, the more difficult it will be to resolve. In short, doing nothing would be highly irresponsible, and would call into question the sincerity of congressmen who purport to be legislating on behalf of the nation.

The second alternative is to raise taxes. That could mean an income tax increase, with the money transferred to Social Security. But the most obvious tactic would be to hike payroll taxes, though another possibility would be to increase income tax levies, since the trust fund is a misleading fiction. The usual advocates of expansive social spending, including Sen. Barack Obama, favor this option.^{xxx} Payroll rates could be increased and/or the income cap on payroll levies, currently set at \$102,000, could be lifted. (Senator Obama wants to lift the cap, but exclude income between \$102,000 and \$250,000, a bizarre idea that mimics the much reviled “donut hole” in disappearing coverage for the Medicare drug benefit. But Senator Obama would apply that threshold to “household” rather than individual, income, hitting more families with higher levies.^{xxxi} John McCain has said that “everything is on the table,” though he has not indicated which form of tax increase he would prefer.)

The flaws in this approach are many. First, any tax-driven “solution” would do nothing to address Social Security’s structural flaws. Moreover, the increase in revenues would have to be huge. Eliminating the payroll tax cap, for instance, would be the largest tax hike in U.S. history—\$472 billion over the first five years was the estimate three years ago.^{xxxii} Andrew Biggs of the American Enterprise Institute warns that the marginal tax rate for high income taxpayers would leap from 37.9 percent to 50.3 percent.^{xxxiii} AEI’s Lawrence Lindsey figures that the marginal rate under Senator Obama’s plan would be 53 percent, while Michael Tanner of Cato estimates it at 55 percent. The result would be a higher marginal rate than in many

high-tax European nations.^{xxxiv} Yet despite the enormity of the tax hike, it would put off Social Security's financial crisis only seven years.^{xxxv} An analysis of Senator Obama's plan reveals it would cover less than one-third of the system's predicted \$6.6 trillion shortfall.^{xxxvi} Thus, to "fix" Social Security, taxes would have to go up more; much more. Such a huge tax hike, through whatever mechanism, would have enormously negative economic consequences, slowing economic growth, business creation, and new employment.^{xxxvii} This would, in turn, further undermine Social Security's solvency, forcing even further tax increases.

Raising payroll levies would substantially increase the price of hiring additional labor -- one of the main disadvantages of a payroll tax. Economic studies conclude that payroll tax hikes in 1979 and 1982 likely permanently eliminated a half million jobs.^{xxxviii} Lifting the payroll cap or resorting to use of general revenues through an income tax increase would completely destroy the notion that Social Security is social insurance, where retirement benefits are linked to contributions. Doing so is a defensible policy position, but is a radical change in direction for what has always been marketed as social insurance.^{xxxix} It would make more sense to rethink the program entirely, rather than to graft purely redistributionist ends on top of a social insurance means.

Finally, tax hikes would target the wrong people. Current beneficiaries are receiving benefits based on paying lower taxes in the past. Future beneficiaries would be forced to pay more, even though they already are slated to receive a lower ROR and likely will receive even lower payments due to future cuts. Raising the taxes of those now in and entering the work force would push down their rate of return even more rapidly, and thus make the system even less fair.

A related tactic would be to expand coverage to state and local government workers. Doing so would have only a small impact on Social Security's financial shortfall, but would spread the misery by forcing more people into a system with a poor rate of return. It would be better to fix the current system by remaking its structure than by conscripting more taxes from more people.

The third option is government investment in the stock market; that is, to create a genuine trust fund in which the government earns money with which to pay promised Social Security benefits. This proposal accepts the argument for privatization—that workers are being defrauded by today's pay-as-you-go system—but refuses to trust workers to make their own retirement decisions.

Putting investment decisions in the hands of the federal government rather than families would be extraordinarily bad policy. First, while private investors make mistakes, they usually bear the costs of their mistakes. Government investment would ensure that everyone bore the cost of government workers' mistakes. Second, individual circumstances change, so a decentralized, flexible, private system tailored to

every family's particular needs makes far more sense than a centrally-controlled, paternalistic government-controlled system. Third, government management means no private ownership. Those who die prematurely still would receive nothing, while those who died later would have nothing to bequeath to their heirs.

Finally, giving the federal government control of trillions of dollars to invest in private companies creates an enormous opportunity for abuse. The history of state pension funds demonstrate the temptation for political actors to seek an opportunity to influence investments for parochial purposes. Even more frightening is the potential influence that government would amass through widespread investment in the stock market, in particular. Former Federal Reserve Chairman Alan Greenspan warned that such an approach would "have very far reaching potential dangers for a free American economy and a free American society."^{xl}

The Better Private Alternative

True reform of Social Security requires shifting control of retirement decisions to workers and their families, by changing Social Security from a government pay-as-you-go system to an individualized system of private accounts. In the long-term this would expand freedom of choice, increase retiree returns, and reduce government expenditures. In the short-term cuts in Social Security benefits and other government outlays, and possibly federal borrowing, would be necessary to finance the transition, during which workers would be increasingly allowed to shift their tax payments into private accounts while the government continued to pay current beneficiaries.

Ironically, this approach fits with President Franklin Roosevelt's original objectives. In creating the program, he said in August 1935 that Social Security would give "some measure of protection to the average citizen and to his family," not provide a full retirement income.^{xli} Moreover, in describing the system he hoped to create, he spoke of "compulsory annuities that in time will establish a self-supporting system for those now young and for future generations," as well as "voluntary contributory annuities by which individual initiative can increase the annual amounts received in old age."^{xlii} (In the immediate term Social Security disability and survivors' benefits would continue to be provided as usual by the System. However, this program warrants attention as well.^{xliii})

Private Accounts. The essential starting point for any serious reform effort is to establish individual private accounts (IPAs). Specific proposals vary in detail, but they all allow workers to shift a portion of their 12.4 percent (combined) payroll tax into private investments. At least at the start, government would certify "approved" investments. Various means, from traditional investment houses to private, self-

regulating clearing houses, to government-contracted private fund managers have been advanced for creating approved investment funds and managing the accounts.^{xliv} Some reformers have advocated allowing workers to invest two to three percent of their 12.4 percent tax payment, but the lower the starting point the longer the transition process to a fully self-funded private system. Moreover, starting slow creates a political disadvantage: Those ideologically committed to government control of people's retirement incomes will oppose even a minor move towards private investment accounts, while the smaller the number reduces the incentive for workers to rally to reform.^{xlv}

Most of the serious initiatives have suggested a higher starting point (though many of these remain low). For instance, President George W. Bush proposed allowing workers to devote four percent to go into private accounts, though the total amount would initially have been capped at \$1000.^{xlvi} Rep. Paul D. Ryan would allow workers under the age of 55 to devote one-third of their taxes to private accounts.^{xlvii} Michael Tanner of the Cato Institute suggested half, or 6.2 percent.^{xlviii} The National Center for Policy Analysis proposed a complicated plan allowing for worker contributions to personal retirement accounts, with a portion funded from their payroll taxes, and the amount varying by income.^{xlix} Peter Ferrara of the Institute for Policy Innovation proposes allowing ten percent of the 12.4 percent on the first \$10,000 in income and five percent on the rest to be invested in private accounts.¹

The accounts should be an alternative rather than an addition to today's Social Security benefits. The reform would be most effective if workers had a right to increase the share of private investment over time. And if, as part of the learning process for those who had not previously invested much, accounts were initially restricted to a number of diversified investment funds, the investment limits could be relaxed over time.

This approach should be particularly appreciated by younger workers. A decade ago a poll of 18-to-34-year-olds found that only 25 percent believed Social Security would still exist and only nine percent believed it would have the funds necessary to pay their benefits when they retired (in fact, more believed in UFOs than in Social Security's future).^{li} More recently a more systematic survey by the National Bureau of Economic Research found that just 40 percent of 30-year-olds believed that they would receive their promised benefits.^{lii}

Investing a larger share of taxes in a personal account should be accompanied a corresponding reduction in future Social Security benefits. Doing so would reduce future outlays and minimize future federal involvement in retirement decisions. Indeed, trading promised Social Security benefits for the opportunity to invest privately would directly reduce the amount of unfunded liabilities.

Thus, those who open private accounts should receive pro rata benefits reflecting their remaining tax contributions to Social Security. In effect, they should be assessed an “offset” against government benefits based on private account contributions and earnings.^{liii} If their contribution level is high enough for long enough, they could simply forego any future accrual of Social Security benefits.^{liv} Those receiving reduced benefits could be provided with a recognition bond reflecting their payments due, redeemable upon retirement.

Those aged 55 or above would remain in Social Security as presently constituted. Those under 55 now working would be allowed to choose whether to open private accounts or trust in the traditional system. Those newly entering the workforce would be enrolled in the private system, with the role of private accounts rising over time, allowing the eventual phase-out of the government’s pay-as-you-go system. Many of the proposals would allow people to continue choosing traditional Social Security, but it makes more sense to terminate that option for those entering the work force, shifting everyone to private funded investment accounts.

Such a system of private accounts would not be a jump into the unknown. More than a quarter-century ago, in 1981 Chile switched from a pay-as-you-go system to private investment accounts. Fully 95 percent of workers chose to invest their tax contributions rather than to remain in the old system. Like any other public policy initiative, the switch was not without occasional problems, but overall the program has been a great success, providing Chileans with higher returns, a large investment corpus as their personal property, and a more prosperous economy.^{lv} A score of other countries ranging across Asia, Europe, and Latin America have followed Chile’s lead and created some variant of private, self-funding accounts. The programs vary in their details, but have delivered more retirement benefits at less cost—and without threatening to bankrupt their respective governments.^{lvi} In 1981 the county of Galveston, Texas, actually used its option to withdraw from Social Security (an option available to all states and localities that was terminated by the 1983 “reform” package) and establish a program based on private investment accounts.^{lvii}

The principal fiscal challenge arising from private accounts would be the so-called transition cost, that is, financing Social Security benefits for current beneficiaries while current workers are shifting tax payments into private accounts. In effect, the current generation must pay twice: There is no escaping the budget pain of financing what the shift between a pay-as-you-go system and a self-funded system would cost. However, under the reform program outlined here, the costs peak early and begin to diminish, in contrast to the present system, in which the red ink explodes and never ends.

The transitional cost depends heavily on the portion of taxes shifted into private accounts as well as the amount of Social Security benefits foregone. The latter

would be low in the beginning, since it would apply to workers in proportion to their years left in the work force. Social Security FICA taxes will bring in about \$576 billion this year. Income will rise to \$714 billion in 2012. Thus, a 20 percent diversion of tax payments would “cost” \$128.8 billion in 2010. A 40 percent shift would run \$258 billion. Increasing the diversion rate would increase the short-term costs but more quickly end new recipients entering the program, and thus cut long-term costs.

Over the long-term payments would disappear as people increasingly opted for private investments. The National Center for Policy Analysis figures that its system would result in a self-funding Social Security System in about three decades.^{lviii} Chile paid for the transition with a mix of borrowing, other spending cuts, and increased revenue transfers (funded by a growing economy).^{lix} In the short- to mid-term the transition in the U.S. could be paid for in two ways. Most important, current benefits should be trimmed. Although doing so would reduce the rate of return for current beneficiaries, they are receiving a far better return than future beneficiaries, who would be penalized by any tax hike. Benefit cuts are undesirable, but at least they would move towards equalizing the rate of return over generations. Trimming payments certainly is more fair than hiking taxes, which would only exacerbate the system’s existing infirmities.

Adjust Wage Indexation. The formula for the benefit accrual of workers is currently adjusted for wage productivity, not prices. (In contrast, the consumer private index is used to adjust the benefits when they are paid to retirees.) Since wages tends to increase about one percent more a year than prices, benefits increase at a rate greater than that of inflation. As a result, after adjusting for inflation, a worker retiring in 2030, 2050, and 2080 is set to receive benefits 18 percent higher, 47 percent higher, and more than double that for someone retiring in 2008.^{lx} (Ironically, there is evidence that this factor causes a growing economy with rising wages to actually worsen Social Security’s financial viability, since long-term liabilities rise faster than short-term tax collections.^{lxi}) We can no longer afford to devote this “productivity dividend” to Social Security benefit increases. Simply adjusting payments to the CPI instead would significantly lower future expenditures. This would not be a cut in benefits, but rather, a reduction in an increase that we can’t afford.

This step could have an enormously positive impact on the system’s long-term finances. Andrew Biggs explains that “Price indexing by itself could restore Social Security to sustainable solvency, as tax revenues could continue to rise in real terms while benefits rose only with inflation.” He adds that deficits would persist over the next six decades “due to the overhang of benefits already accumulated and changing demographics, over time the program would be restored to positive cash flow and even to surpluses.”^{lxii}

Reform should not stop with this step, however, since unexpected financial and demographic changes could still unbalance the system. Moreover, price indexation would further reduce the rate of return for future retirees. Thus, private accounts remain the better system irrespective of finances, though the financial crunch is the principal practical issue likely to force Congress to act on reform.

Increase the Retirement Age. Social Security began as the perfect program: almost half of people died before collecting a penny. Politicians could win votes by promising benefits, but then not have to pay off. Increasing life expectancy has changed that. Life expectancy has increased from less than 60 years in 1935 to 78.1 years in 2006.^{lxiii} That's good news for individuals and families, but bad news for the federal treasury. By 2040 beneficiaries are likely to live an extra 18 years after starting to collect Social Security benefits.^{lxiv} Under previous legislation the retirement age will increase gradually until it hits 67 for those born in 1959 or later. That increase should be accelerated, the retirement age should be increased even more over time, and the early retirement age, now 62, should be increased commensurately. Both should then be indexed to longevity increases. Beneficiaries still would be better off financially, since they would be living relatively longer than the retirement age had been increased, but federal payments would be reduced. The Government Accountability Office figures that this step would have a "small to moderate reduction in the actuarial deficit."^{lxv}

Another advantage of increasing the retirement age would be to encourage greater individual and family preparation for retirement, an important factor when two-thirds of Baby Boomers lack sufficient resources to maintain their living standard post-retirement. Spending a longer time working would allow them to accumulate greater private assets.

Moreover, increasing the retirement age would improve economic growth. McKinsey & Co. warns that the retirement of the Baby Boomer bulge will slow the economy. Explains a recent McKinsey report: "The economy's potential growth rate depends on increases in the labor force, productivity, and capital investment. If the workforce expands more slowly and the other two factors stick to their long-term trends, GDP will rise more slowly as well." McKinsey proposes increasing the median retirement age by two years. The firm concludes: "Higher labor participation would significantly boost overall growth, enabling the economy to generate \$12.9 trillion more GDP between now and 2025 than would occur under the baseline forecast."^{lxvi}

Other Benefit Adjustments. The computation of an individual's Social Security benefits is highly arbitrary, based on various statutory formulas. For instance, the current benefit computational period is the 35 highest years' wages. Increasing that to 38 years would include more low wages years, thereby reducing benefits by about three percent, according to former Social Security Commissioner Robert M.

Ball.^{lxvii} The cost of living adjustment could be trimmed by .5 or one percent, to reduce unaffordable payments. Simply fixing the consumer price index, which is thought to overstate inflation, would reduce benefits, and do so while keeping beneficiaries constant with inflation.^{lxviii} The spouse's benefit, which is why one-earner families do disproportionately better than other Social Security recipients—but still not well, compared to private accounts—also could be pared back or eliminated, as suggested by Henry Aaron of the Brookings Institution.^{lxix} The benefit formula could be adjusted in other ways, reflecting the highly technical manner in which benefits are determined. These sort of changes could have large or small impacts on system financing, depending upon the exact formulas changed, and how.^{lxx}

Other Spending Cuts. The more substantial the diversion of tax payments to private accounts, the harder it will be to arrange the transition without an infusion of general revenues, irrespective of any proposed benefit cuts. For instance, Peter Ferrara's proposal would require an infusion peaking at 7.25 percent of taxable payroll in two decades.^{lxxi} Rep. Paul Ryan's current proposal would require transfers in the \$400 to \$500 billions from around 2030 to 2050, with smaller amounts thereafter.^{lxxii}

Thus, benefit cuts, though an important part of the reform package, are unlikely to be sufficient to balance the Social Security reform ledger during a transition from pay-as-you-go to self-funded systems. That makes it even more important to cut federal outlays elsewhere. Substantial savings would be possible by targeting three major areas. First, freezing domestic discretionary outlays could save nearly \$200 billion a year. Eliminating corporate welfare, the amalgam of unnecessary and abused business subsidies, could save around \$100 billion a year. Military spending, which at \$538 billion next year (not counting \$150 billion or more for Afghanistan and Iraq) will run more in real terms than at any point since World War II, has been grossly inflated by America's emphasis on protecting wealthy allies and engaging in nation-building. Focusing on America's *defense* would allow substantial cuts of well over \$100 billion annually.

Moreover, the transfer of some general revenues could be justified by the fact that taxes would be collected on private investment income generated by the new accounts. The Social Security Administration itself predicted that this revenue would provide "a substantial and growing source of income" for the program.^{lxxiii} Moreover, since the move to a self-funded system would ultimately extinguish public liabilities, it would be acceptable to borrow, if necessary, to fund the transition.

Other Program Adjustments

Social Security warrants two additional changes which are not directly related to making the system solvent. However, both steps would help ensure the success of the larger reform package.

Fix the Earnings Test. Retirees aged between 62 and 66, that is, those who retired early, have their benefits reduced \$1 for every \$2 earned over \$13,560. But, in contrast to the early years when this provision first limited eligibility for any benefits and then cut benefits by 50 percent for anyone up the age of 70, the rule now merely postpones receipt of those benefits. After reaching 66, beneficiaries receive back the deferred benefits. Unfortunately, most retirees don't understand the difference in rules and many reduce work to avoid, in their minds, losing benefits.

As Andrew Biggs observes, "Working less is exactly what most seniors should not do. With life spans rising, traditional pensions declining, and Social Security benefits in need of adjustment, working longer may be the best way for individuals to improve their retirement security. Researchers at the Urban Institute estimate that an additional year of work would increase the typical retiree's income by 9 percent; a five-year delay in retirement would increase total income by 56 percent."^{lxxiv}

The earnings test should simply be eliminated. It saves the government a little money—a few beneficiaries die before recouping the delayed payments, and the government saves a little by paying later rather than sooner, but the gain is not worth the lost labor. It has been estimated that lifting the retirement test on retirees between 66 and 70 increased the number of hours worked by men between 12 and 17 percent.^{lxxv} Raising the number of hours worked by seniors would both enhance the earnings of retirees and improve the system's cash-flow at a time when it faces growing losses.

Budgeting Reforms. Entitlements programs are harder to control than discretionary expenditures since outlays are driven by statutory eligibility requirements rather than by explicit appropriations. Every three to five years Congress should subject the Social Security program to an automatic funding review, assessing future projections and considering any changes necessary to maintain the system's financial stability. Congress also should establish a system of automatic benefit cuts and advances in the retirement age to kick in the following year should spending exceed budgeted outlays.^{lxxvi} Legislators could substitute an alternative funding measure, but inaction would allow an automatic fiscal adjustment. Thus, even a Congress inclined to avoid taking hard decisions could not bankrupt America by doing nothing.

This sort of system would be particularly important because even significant reforms, if they do not lead to a phase-out of the program, do not guarantee permanent solvency. So long as a government system exists, economic and

demographic changes will affect future collections and pay-outs. Eternal vigilance mixed with flexibility is required to protect the American people from again facing a program meltdown and potentially trillions of dollars in unfunded liabilities.

One Possible Proposal

A wide variety of specifics are possible and the details could be negotiated. But the essential goal is to move from a government-run, government-funded, pay-as-you-go retirement program to a system of private accounts owned and controlled by individuals and families. A good starting point would be:

- * Private retirement accounts would be established for all workers under 55.
- * Those just entering the workforce or who had been in the workforce no more than four years could begin by contributing half of their Social Security payments, 6.2 percent, and increase their contribution by one percent a year, topping out at 10.2 percent. After four years they would graduate from the system, and would be entitled to no benefits under Social Security. Those already in the workforce five or more years could start at 4.2 percent and increase their contribution a half percent a year. They could top off at 8.2 percent, after which they would accrue no more Social Security benefits. Their Social Security payments would be offset to reflect their choice to contribute to PRAs.
- * The remaining two to four percent tax payments would be used to finance disability and supplemental payments as well as existing retirement benefits. These payments would be adjusted as the number of Social Security beneficiaries fell and if the disability and supplemental insurance program was similarly transformed into private accounts.
- * Existing benefits would be curtailed first by relying on price rather than wage growth, and second by increasing the retirement age to reflect increased longevity, adjusting the consumer price index to more accurately capture price inflation, and reducing the spousal benefit to accommodate changing family structure.
- * To free up necessary resources, nonessential federal programs elsewhere would be eliminated or sharply cut. Two large areas of potential savings are corporate welfare and military outlays directed at supporting allied states rather than defending America. Domestic discretionary programs, especially those with no constitutional warrant, also would be targeted.
- * Finally, if necessary, the government would borrow to help fund the transition from today's government pay-as-you-go program to a private, self-funded program. Upon completion of the transition, federal outlays would drop dramatically, allowing repayment of any accumulated debt.

Conclusion

We must act, and we must act soon. The problem is clear and the solutions are available. What so far has been lacking is the courage to act. However, if we care about the future of our nation and our people, we have no choice but to act soon.

David M. Walker, the Comptroller General of the United States, told the Congress three long inaction-filled years ago: “Failure to take steps to address our large and structural long-range fiscal imbalance, which is driven in large part by projected increases in Medicare, Medicaid, and Social Security spending, will ultimately have significant adverse consequences for our future economy and the quality of life of our children, grandchildren, and future generations of Americans. As a result, the federal government needs to engage in a fundamental review, reassessment, and reprioritization that will ultimately have to span all major spending programs and tax policies.”^{lxxvii}

We cannot afford to wait any longer. One of the most important tests for the next president is a willingness to lead, even in the face of entrenched political opposition. No where is that more clear than when it comes to reforming Social Security. The American people deserve to have a retirement system which they can count on.

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