A Progressive Proposal for Social Security Private Accounts

by Peter Ferrara | Publications | Policy Report

Synopsis

A well-designed personal account option for Social Security would be substantial, highly progressive, and would provide a broad array of benefits and advantages for working people across the board, including low-income workers, minorities, and others. But what is needed is a concrete, specific and detailed proposal for reform that delivers on the promise of a true personal account option. This study provides such a proposal.

Executive Summary

A well-designed personal account option for Social Security would be substantial, highly progressive, and would provide a broad range of benefits for working people, including the following:

- Workers would enjoy personal ownership and control over their retirement funds.
- Workers would receive much better returns on what they and their employers pay into the system and substantially higher retirement benefits than the current Social Security system promises, let alone what it can pay.
- Low-income workers, minorities and women would receive much higher returns and benefits through these personal accounts than through the current Social Security framework.
- Personal accounts would offer low- and moderate-income working people their only real chance to accumulate substantial savings and wealth. This would result in broader and more equal ownership of wealth and capital.
- Since private capital market returns are so much higher than what Social Security can pay, the required payments into personal accounts can be substantially less than what Social Security currently demands. This would effectively amount to the largest tax cut in world history.
- The reduced tax burden and higher savings and investment resulting from personal accounts would substantially boost economic growth. This would result in more jobs, better jobs, and higher wages and overall income.
- To the extent workers choose personal accounts to provide their Social Security coverage, the Social Security financing crisis would be eliminated, without cutting Social Security benefits or increasing Social Security taxes, as workers rely on fully funded personal accounts for their benefits rather than upon the older Social Security framework.
- In the process of transition to a system of personal accounts, the unfunded liability of Social Security, which is three times the reported national debt, would be eliminated. This would amount to the greatest reduction in government debt in world history.

The public understands all of this. Polls show very broad and strong support for personal accounts, and politicians, including the President of the United States, are already running and winning elections on this issue.

What is needed now is a specific reform plan that delivers on the promise of personal accounts, providing all of the benefits discussed above. This study offers just such a reform plan.

The personal account plan described in this study will accomplish all of the above and will completely eliminate the Social Security deficits over time, without Social Security benefit cuts or tax increases. It is a plan upon which fiscal conservatives and social liberals, Republicans and Democrats, and homemakers and policymakers can agree, for the betterment of all Americans.

Summary Outline

A Progressive Proposal for Social Security Personal Accounts

1. Workers would be free to choose to save and invest 5 percentage points of the 12.4 percent Social Security payroll tax in their own personal account. However, on the first $10,000 of income they would be able to double this amount, paying 10 percentage points of the tax into the account.
2. The accounts are progressive because of the extra contributions for the lowest portion of earned income. Due to these contributions, low-income workers can

invest a bigger portion of their payroll taxes and incomes in the accounts than can high-income workers. A worker earning $15,000 would effectively be able to invest 8.3 percentage points of the Social Security tax into the account. A worker earning $20,000 would effectively be able to invest 7.5 percentage points of the payroll tax into the account. A worker earning $50,000 would effectively be able to invest 6 percentage points in the account. With these progressive contributions, low-income workers should be able to gain at least as much from the accounts on a proportional basis as upper-income workers.

3. Those already in the work force when they exercise the personal account option would continue to receive a portion of the Social Security benefits promised under the current system based on the taxes they and their employers paid into the system in the past, in addition to the benefits from the personal accounts. This would ensure these workers would be able to gain the benefits of the reform as well.
4. Initially, the portion of the Social Security payroll tax not shifted to the personal account would continue to be paid for a period of years to help finance the transition. But eventually this portion of the tax would be phased out, split evenly between employers and employees. This would ultimately amount to a large payroll tax cut for workers and businesses.
5. The Treasury Dept. would contract with a number of private fund managers to offer investment funds to workers who exercised the personal account option, as in the Federal Employee Thrift Savings program. These funds would be subject to Treasury Dept. regulation requiring diversification of assets and other safety measures. Workers exercising the personal account option must choose among these alternatives on the Treasury Dept.'s list for investment of their funds. A worker would only have the responsibility of choosing among these funds, and the fund managers would pick the particular stocks, bonds or other investments.
6. Investment returns would accumulate in the accounts tax-free, and any funds remaining at death could be passed to children or other heirs free of the death tax.
7. At retirement, workers could choose to put some or all of their funds in an annuity, or make periodic withdrawals subject to Treasury Dept. regulation ensuring all of the funds weren't withdrawn too quickly. All of these benefits would be tax-free.
8. The entire system would be backed up by a safety net providing a guaranteed minimum benefit equal to at least what Social Security would have paid without the account.
9. Only workers below age 55 at the time the account is first offered can choose to exercise it. But once they do exercise it, they can continue to devote the specified portion of their payroll taxes to it for as long as they work and pay payroll taxes.
10. There would be no change in current benefits for those retired today. Future Social Security benefits for those who did not exercise the option would not be changed by this legislation either. Workers would be free to choose to stay in the current Social Security system.
11. Social Security disability benefits, and survivors benefits for workers who die before age 65, would continue to be provided by the old Social Security framework as today, and would not be affected by the personal accounts.
12. The transition would be financed by general revenues paid into the trust funds to ensure that all benefits continue to be paid. Those general revenues would ensure that the reform plan does not reduce the trust funds from their currently projected levels under current law, or deplete the trust funds any faster than projected. The President would specify in his budget each year exactly where the resources would come from to finance the general revenue contribution needed for the transfer. The funding sources would include current Social Security surpluses, the extra taxes produced by higher savings and investment, and by higher overall economic growth.
13. The net remaining transition deficit each year after the factors above would be financed by issuing federal bonds in an off-budget federal account. The account would consequently not be part of the annual deficit or surplus calculations in the general federal budget. These bonds do not involve new government debt, but just explicit recognition of the effective debt already existing in the unfunded liabilities of Social Security. These bonds could then be paid off over a 30 to 40 year period. The reform itself would ultimately produce surpluses that would help pay off the bonds.

Introduction

Much of the groundwork has already been laid developing the rationale for allowing workers the freedom to choose a personal savings and investment account in place of at least part of their current Social Security coverage. See, e.g., Peter Ferrara, *Social Security: The Inherent Contradiction* (Washington DC: Cato Institute, 1980); World Bank Policy Research Report, *Averting the Old-Age Crisis: Policies to Protect the Old and Promote Growth* (New York: Oxford University Press, 1994); Marshall Carter and William Shipman, *Promises to Keep: Saving Social Security's Dream* (Washington, DC: Regnery Publishing, 1996); Dorcas Hardy and C. Colburn Hardy, *Social Insecurity* (New York: Villard Books, 1996); Sam Beard, *Restoring Hope in America* (San Francisco, Institute for Contemporary Studies, 1996); A. Haeworth Robertson, *The Big Lie: What Every Baby Boomer Should Know About Social Security and Medicare* (Washington, DC: Retirement Policy Institute, 1997); Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington, DC: Cato Institute, 1998); Sylvester J. Schieber and John B. Shoven, *The Real Deal* (New Haven: Yale University Press, 1999); Wade Dokken, *New Century, New Deal* (Washington, DC: Regnery Publishing, 2001); Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," American Economic Review, Vol. 12, p. 86 (May 1996); William W. Beach and Gareth G. Davis, *Social Security's Rate of Return*, A Report of the Heritage Center for Data Analysis, Washington, DC, No. CDA98-01, January 15, 1998; Melissa Hieger and William Shipman, *Common Objections to a Market Based Social Security System: A Response*, SSP No. 10, The Cato Institute, Washington, DC, July 22, 1997; William Shipman, *Facts and Fantasies About Transition Costs*, SSP No. 13, The Cato Institute, Washington, DC, October 13, 1998. This is not meant to be a comprehensive list of all the good books and especially studies that have been written on this issue, which would be impossible, and I apologize in advance to the many authors who have written valuable materials on the subject that are not included here.
That rationale is now broad, multifaceted and well supported.

Personal Ownership. The accounts would allow workers personal ownership and control over their retirement funds and broader freedom of choice. Workers could choose among investment funds managed by major investment firms. They would have more choice over their retirement age, and could choose to leave substantial funds to their children or other heirs. They would also be free to choose whether to exercise the personal account option or stay entirely in the old Social Security framework.

Superior Returns. Social Security's aging pay-as-you-go system offers today's workers a low, below-market return on the taxes they and their employers pay into the system. For many, the return is zero or even negative. These workers would now be able to get far higher returns and benefits relying on diversified investments in the capital markets.

True Security. The U.S. Supreme Court has explicitly held that Social Security is not government guaranteed like U.S. bonds are, and that Social Security benefits can be reduced or cut off by Congress anytime it chooses. Personal accounts, by contrast, would be true forms of wealth owned by the account-holder.

Progressive Effects. Even though the current Social Security system contains a strong redistribution element, personal accounts would improve the retirements of lower-income and minority workers. African-Americans (who get a particularly bad deal through Social Security because of their below-average life expectancy) would be able to use their personally owned, accumulated resources in their accounts to gain even higher benefits during their relatively fewer retirement years. Hispanics would also gain because they are younger on average than the general population, and personal accounts provide bigger gains the younger a worker is.

Expanding the Investor Class. Personal accounts would provide low- and moderate-income earners their only real chance to participate in investment markets, and accumulate substantial savings and capital. This would result in much broader and much more equal ownership of wealth and capital, which should increase support for pro-growth economic policies, whose broad benefits would then be more direct and transparent.

A Tax Cut. Since capital market returns are so much higher than what Social Security promises, the required payments into personal accounts can be substantially less then current Social Security taxes, which could represent a major tax cut for workers and their employers. Indeed, over time the reform would transform public Social Security taxes into private retirement payments by workers and their employers into each worker's privately owned personal savings and investment account. This would effectively amount to the largest tax cut in world history.

Boosting Economic Growth. The reduced tax burden and higher savings and investment resulting from personal accounts would substantially boost economic growth, which translates into more jobs, better jobs, and higher wages and overall income.

Solving the Enormous Social Security Liability Crisis. Social Security faces a long-term financing crisis, which would require raising current payroll taxes by 50 percent, and perhaps more in order to pay all benefits promised to today's young workers. To the extent that personal accounts displace the old Social Security system, this financing crisis would be eliminated, as workers retire relying on fully funded personal investment accounts for their benefits rather than Social Security. Because of the wealth-producing effects of the accounts, Social Security's financing problem can be solved without cutting Social Security benefits or raising Social Security taxes. Indeed, as discussed above, retirement benefits would actually be higher and the current Social Security tax burden would ultimately be reduced. In the process, the unfunded liability of Social Security, which is three times the reported national debt, would be eliminated, amounting to the greatest reduction in government debt in world history.

A Worldwide Pension Reform Movement

Other countries around the world have adopted personal account options for their Social Security systems, with good results. As is well known, the revolution started in the South American nation of Chile. Chile's reforms are discussed in Jose Pinera, "Empowering Workers: The Privatization of Social Security in Chile," Cato's Letters No. 10, July, 1996; Sergio Baeza, *Quince Anos Despues: Una Mirada al Sistema Privado de Pensiones* (Santiago: Centro de Estudios Publicos, 1995); Marco Santamaria, "Privatizing Social Security: The Chilean Case," Federal Reserve Bank of New York, Research Paper no. 9127, Nov., 1991; Robert Myers, "Privatization of Chile's Social Security Program," *Benefits Quarterly*, 1, no. 3, (Fall, 1985): 26-75; Jose Pinera and Mark Klugman, *The Chilean Private Pension System* (Santiago: Superintendence of Pension Funds Administrators, 1996); Peter J. Ferrara, John Goodman and Merrill Mathews, *Private Alternatives to Social Security in Other Countries*, National Center for Policy Analysis, Dallas, Texas, NCPA Policy Report No. 200, October, 1995.

Starting in 1981 Chile allowed its workers the freedom to choose a personal savings, investment and insurance account in place of its old system. In less than 2 years, over 90 percent of workers chose the personal accounts. The Chilean system was such a great economic and political success that seven other nations in Latin America have now adopted similar systems -–Argentina, Mexico, Peru, Colombia, Uruguay, Bolivia and El Salvador. Jose Pinera, *Liberating Workers: The World Pension Revolution,* Cato's Letters No. 15, Cato Institute, Washington, DC, 2001.

But the trend has now expanded well beyond Latin America. In Great Britain, about 80 percent of workers have opted for private savings and investment alternatives in place of a major portion of the old government system there. Lou Enoff and Bob Moffitt, "Social Security Privatization in Britain: Key Lessons for America's Reformers," Backgrounder No. 1133, Heritage Foundation, Washington D.C., August 6, 1997.

In 1991, Australia replaced its old public system with a personal investment account system. Dan Mitchell, Australia's Privatized Retirement System: Lessons for the United States, Backgrounder No. 1149, Heritage Foundation, Washington DC, Dec. 8, 1997

The trend began to expand in Europe in the late 1990s, with personal account systems adopted in Hungary, Poland, Switzerland, Denmark and the former Soviet Republic of Kazakhstan. Indeed, even in socialist Sweden workers now have the option of choosing to save and invest 2.5 percentage points of their payroll tax in personal accounts. The reform is even now spreading into the former citadels of communism, with both Russia and China taking steps to move to personal account systems. Pinera, *Liberating Workers;* Estelle James, Social Security Reform for Other Nations, Heritage Lecture No. 618, June 4, 1998, p. 4.

Coming to America

While behind the international curve, the United States offers its own successful recent example of an alternative to the old Social Security framework. Merrill Mathews, *No Risky Scheme: Retirement Savings Accounts that Are Personal and Safe* , IPI Policy Report No. 163, January 11, 2002. Soon after Chile adopted its personal account system, three counties around Galveston, Texas, exercised the option in U.S. law at the time that allowed state and local workers to opt out of Social Security. These workers enrolled instead in a personal account system with much higher benefits than Social Security promises, at lower costs.

The American public seems quite ready to bring such a system to the U.S. For several years, polls have shown startling public support for a personal investment account option for Social Security. These polls are reviewed in Peter Ferrara, "Short-circuiting the Third Rail: Social Security Personal Accounts and the Traditional Family," *Family Policy Review*, Vol. 1, No. 1, Spring 2003. The most recent was a Zogby International poll finding that by an astounding margin of 68 percent to 29 percent the public 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 to 28 percent, union households by 64 percent to 34 percent, and African-Americans by 58 percent to 39 percent. Even Democrats as a whole supported it by 56 percent to 40 percent.

Similarly, a Reuters-Zogby International poll taken in June, 2000 found the public favoring such an option by 65 percent to 27 percent. In January, 2000, a CNN- *USA Today* poll found the public favoring the idea by 62 percent to 33 percent.

A 1999 *USA Today* poll found the public strongly opposed to every major change regarding Social Security except one, a personal investment account option, which was favored by 66 percent. An AP poll taken in December, 1998, found 75 percent of Americans supporting a personal account option. In 1997, Mark Penn conducted a poll for President Clinton that found that 73 percent of *Democrats* would favor a personal account option as a replacement for at least part of the Social Security program.

In a 1996 poll for the Cato Institute, Bill McInturff of Public Opinion Strategies found the public favoring personal accounts by 68 percent to 11 percent. Finally, a 1995 poll conducted by Luntz Research for the seniors organization 60Plus, found the public supporting a personal account option by 77 percent to 14 percent.

These poll results have been borne out in recent elections. President Bush campaigned quite openly in 2000 on a personal account option for Social Security. He won while actually taking a majority of the senior vote in Florida.

Leading Democrat 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 website featured a cartoon video showing President Bush pushing seniors in wheelchairs off a cliff. Yet these Republican candidates won race after race, including many of the most contested and high profile. Indeed, not one candidate seems to have been defeated on the issue. As national pollster and political handicapper John Zogby reported after the election, "In every race where Social Security was a major issue, the pro-account candidate won." John Zogby, et al., *Public Opinion and Private Accounts: Measuring Risk and Confidence in Rethinking Social Security*, SSP. No. 29, January 6, 2003. p.2.

<u>Across the Spectrum</u>

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. Remarks by former President William J. Clinton at the Democratic Leadership Council, New York University, December 3, 2002, New Democrats Online, www.ndol.org.

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 percentage points of the payroll tax to the accounts. That should be the minimum for any new proposal now.

In addition, on December 9, 2002, the *Washington Post* followed Clinton's comments with an editorial that said the following:

"Beneath the rhetoric there is a surprising degree of consensus among those on both sides of the political spectrum who have studied the issue, about the danger Social Security faces. Because of lower birthrates and longer life spans, the United States is rapidly approaching the time when the current system, in which taxpayers effectively pay the benefits of current retirees, will become untenable. The 12.5 percent payroll tax that now funds Social Security will no longer be sufficient…. So 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." "A Chance for Discussion," *Washington Post*, December 2, 2002, p. A20.

What is needed now is a specific reform plan that delivers on the promise of personal accounts that benefits working people as much as possible, including the lowest income workers and minorities. If the reform is done right, these groups have the most to gain. This study is meant to offer just such a personal account reform plan, achieving all of the goals of such reform with a progressive structure that offers the broadest possible benefits for American workers.

A Compass for Reform

Some reformers have been developing proposals with very small personal accounts, allowing workers to shift only about 2 percentage points of the payroll tax to the account, combined with very large reductions in the long-term growth of Social Security benefits, to solve Social Security's financing crisis. But this is a badly misconceived approach to reform.

What brought about the favorable poll results and the election victories on Social Security are the positive features of personal accounts discussed above. The focus of reformers in originally advancing personal accounts was these positive, populist features, and a fundamental policy goal of shifting away from dependency on government and public taxes and spending, towards reliance on real, personal savings and investment. It was never primarily about the long-term Social Security deficit, and definitely not about cutting benefits and raising taxes to eliminate that deficit as quickly as possible. Indeed, one of the advantages of personal accounts was always that they could address the long term Social Security financing crisis *without* cutting Social Security benefits or raising Social Security taxes.

A substantial personal account option will unwind the long-term Social Security deficit and eliminate the program's unfunded liability without a need for tax increases or benefit cuts. Under this proposal for personal accounts, retiring workers will rely more and more on the real savings and investment in the accounts for their benefits, and less and less on the old Social Security framework. This process would sharply reduce the benefit *obligations* of the old system, reducing the program's deficits and unfunded liabilities. Eventually we would reach the point where almost all workers are relying on the personal accounts for their retirement benefits. Without significant benefit obligations, the old system would no longer have deficits and unfunded liabilities. The proposal advanced below does not apply to disability benefits and survivors' benefits for those who die before age 65. Those would continue to be financed through the current system under present law without change. So the accounts would not directly address the relatively small portion of the long-term deficits and unfunded liability due to those parts of the current system. But since the accounts in the proposal below require only a portion of current payroll taxes for retirement benefits to be shifted to the personal accounts, part of the remainder of those taxes could be devoted to closing any financing gaps in these remaining parts of the current system.

So why unnecessarily mandate Social Security benefit reductions that undermine the whole reform effort? That would just remove the focus from the positive features of personal accounts. Opponents of personal accounts would focus their fire on the benefit reductions, grossly exaggerating the effects of the benefit reductions and blaming them on the accounts. Why hand opponents such red meat to stop reform altogether? And can we really expect slim voting majorities on Capitol Hill to pass these long-term benefit reductions with little or no bipartisan support? Social Security benefits have never been reduced on a party line vote in the past.

Moreover, advancing small personal accounts that allow workers to invest only 2 percentage points of their taxes or less would minimize all of the positive features of the accounts that are giving the reform effort its political life. Little progress would be made on the fundamental goal of reducing dependency on government taxes and spending, and increasing reliance on real, personally owned investment.

A reform package with benefit cuts and small personal accounts would also destroy the grassroots populist appeal of the reform effort. People are not going to organize at the grassroots, contact their representatives, and speak out in public forums for such a reform plan. Without powerful grassroots appeal and organization, fundamental Social Security reform can never be achieved.

Indeed, reformers need to keep in mind that the personal accounts they design must at a minimum be sufficiently appealing to induce workers to exercise the personal account option. Too many of the two percent account advocates seem to overlook the need to make the reformed system much more appealing than the current system. We wouldn't want to go through all the trouble of legislating a personal account option only to find that the accounts are so limited and lacking in any real gain for workers that few, if any, actually exercise the option. Congress has legislated grand reform plans in other areas before, such as in the Medicare system, only to find few takers once the option was in place.

In contrast, a progressive, populist reform plan with a large personal account option and no other changes to the Social Security benefit structure can generate huge, popular, grassroots fervor and political support across the spectrum. Such a reform plan would strongly benefit working people, young people, union workers, minorities, lower income workers, families with children, single people, and virtually everyone else. That is the kind of mighty, grassroots, populist, bipartisan, trans-ideological appeal that would ultimately be necessary to achieve such a major reform in our political system.

A reform plan that can accomplish all of this is proposed below.

A Consensus Plan

The specific details of a personal account reform plan are flexible and can vary widely. Many such widely varying reform plans, in fact, have already been offered. The reform plan proposed below draws on many of these plans to produce a concrete proposal that tries to include all the best ideas that have been advanced from many different quarters, and ultimately aiming to achieve the goals of reform in the most positive, broadly-appealing manner.

A Progressive Proposal for Reform

This reform plan would allow workers the freedom to choose to save and invest 5 percentage points of the 12.4 percent Social Security payroll tax in their own personal accounts. However, on the first $10,000 of income they would be able to double this amount, paying 10 percentage points of the tax into the account. The contributions would come from both the employer and employee shares of the tax.

Such accounts would be quite progressive because of the extra contributions for the lowest portion of earned income. Due to these contributions, low-income workers can invest a bigger portion of their payroll taxes and incomes in the accounts than high-income workers. A worker earning only $10,000 a year would be able to invest 10 percentage points of the Social Security tax into the account. For a worker earning $20,000 a year, the combination of contributing 10 percentage points on the first $10,000 of income and 5 percentage points on everything above that leaves his contribution overall equal to about 7.5 percentage points of the payroll tax. For a worker earning $50,000 a year, that effective contribution would be 6 percentage points.

These personal account contribution levels would enable all workers to get better benefits from the personal accounts than Social Security promises them, assuming standard, long-term market investment returns. The exact amount of the gain would depend on their age when they enter the personal account system, their family situation, their income, and other factors. But most young workers entering the work force today and participating in such a personal account option throughout their adult lives could expect well over 50 percent more than the benefits Social Security promises them (but cannot pay). Indeed, investing more heavily in the higher-yielding investment options, they could expect much more. With the progressive nature of the allowed contributions, lower-income workers would be able to gain at least as much from the accounts on a proportional basis as would higher-income workers.

Private investment fund managers would contract with the U.S. Treasury Dept. to offer investment funds to workers who exercised the personal account option, as in the Federal Employee Thrift Savings Program. The approved firms offering investment funds would all be major financial companies with substantial reserves and assets, and proven long-term track records. Possible account providers could include mutual fund companies, brokerage firms, insurance companies, banks, and others. The investment funds offered would be subject to Treasury Dept. regulations requiring diversification of assets and other safety measures. The personal account funds invested by these companies would be separated from the rest of the activities of the companies, so that if these companies had any financial problems in the rest of their business, it would not affect the personal accounts. If an investment company managing personal accounts went bankrupt in its regular business outside management of the accounts, the government (meaning in this case the U.S. Treasury Dept.) would take over the accounts just as it would a failed bank. The Treasury would pick one of the other investment companies to manage these accounts with the account holders free to choose another investment company any time until the end of the next open season for switching funds.

Workers exercising the personal account option must choose among these alternatives on the Treasury Dept. list for investment of the funds. Each worker would only have the responsibility of choosing among these funds, and the fund manager would pick the particular stocks, bonds or other investments. This would make the personal account option easy even for financially unsophisticated workers, following the model long used in Chile and other countries that have adopted personal account options.

The different funds offered to workers could invest in different combinations of stocks, corporate bonds, government bonds, and other investment vehicles. Stocks have proven to offer the highest long-term investment returns, though those returns are highly variable from year to year. But workers would be able to choose funds that completely avoid stocks if they prefer.

Workers could even choose funds invested entirely in government bonds. Though the return on such bonds would be lower, the investment would be government guaranteed. Indeed, such bonds would enjoy a guarantee that is not a feature of Social Security, since the U.S. Supreme Court has explicitly held that Social Security is not government guaranteed, and that Social Security benefits can be reduced or cut off by Congress anytime it chooses. Fleming v. Nestor, 363 US 630 (1960). Banks can also be allowed to offer their own federally guaranteed deposit accounts as one of the investment fund options. This would also offer workers a true government guarantee, unlike Social Security. Another option is for funds to invest in mortgage pools and perhaps some other real estate related pools with some of their assets. Workers would have the flexibility to diversify their account contributions among a number of these different investment fund alternatives if they prefer.

Unions could sponsor investment fund alternatives to be included among the list of choices, as could membership associations like the NAACP, National Council of La Raza, and AARP. These associations would have to contract with a major investment company that would actually manage the investment funds.

Accounts sponsored by membership associations could be particularly beneficial for specific demographic groups with special considerations. Associations like the NAACP could offer investment funds tailored to the special situations of their members, such as African-Americans. The benefits payable from the fund in retirement could be based on the life expectancy of the membership group, enabling groups with lower- or higher-than-average life expectancies to draw benefits tailored to their life expectancies.

During an open season, workers could choose to switch among investment fund alternatives. The Treasury Dept. would maintain its own separate office responsible for directing each worker’s money to the investment fund he or she chose. Employers would simply continue to pay all Social Security taxes to the Treasury and forward forms on which workers choose to exercise the personal account option and designate the investment fund alternatives they want. The employer would only verify the worker’s salary stated on the form, and the Treasury would immediately start directing contributions to the investment fund chosen by the worker. The Treasury Dept. does a reconciliation of all Social Security tax payments at the end of each year, and at that time the Social Security tax payments made by each worker and his employer can be verified. But based on verified salary information alone the Treasury would know how much to start sending to the chosen investment fund, because the payroll tax is a set percentage of wage income. The form exercising the option and choosing the investment funds can be designed to be completed online. Workers would each be able to monitor contributions to their chosen investment fund and its performance online. This system would involve no significant new administrative burdens for employers.

For those who exercise the personal account option, the portion of the current payroll tax not eligible to be shifted to the personal accounts would continue to be paid for a period of years to help finance the transition. But eventually, this portion of the tax would be phased out, split evenly between employer and employee, for those who exercised the personal account option. This would ultimately amount to a large payroll tax cut for both workers and business.

There would be no deduction for contributions to personal accounts, but investment returns would accumulate in the accounts tax-free. Retirement benefits paid from the accounts would be tax-free as well. Any funds remaining at death could be passed to children or other heirs free of the death tax.

At retirement, workers could choose to use some or all of their funds for an annuity that would pay them a guaranteed monthly income for the rest of their lives. Or they could choose to make periodic withdrawals subject to Treasury Dept. regulation ensuring that all of the funds weren't withdrawn too quickly. They could choose retirement and start to receive benefits from the accounts at any point after age 59 �. But, in general, the more they delay retirement the greater the benefits the personal accounts would pay.

The entire system would be backed up by a social safety net guaranteeing that workers would not fall below a minimum floor of benefits. Chile and every other country that has adopted personal accounts have included such a guaranteed minimum in their reforms. In this plan, the government would guarantee that all workers with personal accounts would get at least what Social Security would have paid them. If for some reason the personal account cannot pay the worker at least that much, the government would make up the difference.

Market investment returns are so much higher than what Social Security can pay, it is quite unlikely that the social safety net will ever bear any significant burden. But it helps workers get comfortable with the new system secure in the knowledge that they are still backed up by a safety net guarantee.

In this plan, only workers age 55 and below can choose to exercise the personal account option. But once they do exercise it, they can continue to devote the specified portion of their payroll taxes to it for as long as they work and pay payroll taxes. Here personal accounts provide another advantage to retirees. Today, those who continue some work after retirement continue to pay Social Security payroll taxes, but they do not get any extra benefits for those taxes. With a personal account, the specified payroll tax contribution would continue to go into the account for any continued work after retirement and would consequently support higher benefits.

Those already in the work force when they first exercise the personal account option would continue to receive a portion of Social Security retirement benefits based on the taxes they and their employers had already paid into the system in the past. That proportion would be calculated as follows. First, we would take the present value of the lifetime Social Security taxes that the worker and his employers paid into Social Security rather than the personal accounts. That sum would then be divided by the present value of the lifetime Social Security taxes the worker and his employers would have had to pay into Social Security without any personal account option. The Social Security retirement benefits the worker would have gotten under current law is them multiplied by this ratio to determine what Social Security benefits a worker who exercised the personal account option would continue to receive.

In short, workers who exercise the personal account option would continue to receive a proportion of currently promised benefits _equal to the proportion of lifetime Social Security taxes each worker and his employers paid into Social Security rather than the personal accounts, on a present discounted value basis. So if a worker and his employers paid over his working years half of the taxes into the old system and half into the personal account, on a present discounted value basis, at retirement the worker would account. If a worker and his employers over his working years paid one-fourth of his taxes into the old Social Security system and three fourths into the personal account, on a present discounted value basis, then at retirement the worker would still get one-fourth of his promised Social Security benefits, plus the benefits of the personal account. For new workers entering the work force after the personal account option is adopted, a worker who exercised the personal account option in full over his entire working career would receive no continuing Social Security benefits in retirement, but would receive higher benefits through the personal account.

The upshot of this is that workers who are already in the workforce at the time personal accounts are adopted would be able to gain substantially from the personal accounts over their remaining working years. Of course, workers would still do proportionally better the sooner they exercise the personal account option, for then they would have more years to earn the market investment returns. This transition rule would also apply to future workers who do not choose to exercise the personal accounts when they first enter the work force, but decide to do so later, as that option would remain open to them at any point up until age 56.

There would be no change in the Social Security benefits promised under current law, or any other change of any sort, for those retired today, or for anyone near retirement (over age 55). In addition, workers would be completely free to remain in the current Social Security system as is, and not exercise the personal account option at all if that is what they prefer.

Indeed, the reform plan would include no changes or reductions in future Social Security benefits either. So workers who may choose to stay in the current Social Security framework would continue to receive the benefits provided under current law. The financing for those benefits is discussed below.

It may seem sensible to offer future retirees, beyond those near retirement today, only the Social Security benefits the system will be able to pay then. But if a large-enough portion of the workforce exercises the personal account option, that benefit reduction would have little or no real-world significance. Workers in the future would be overwhelmingly relying on the personal accounts rather than Social Security benefits, whether those are current law benefits (this plan) or somewhat reduced benefits (other plans). It makes no sense, therefore, to engage in a bloody and uncertain political fight over what those future Social Security benefits should be. That, again, would just take the focus off of the positive features of personal accounts and greatly dampen much needed grassroots enthusiasm for reform. The much wiser course would be to focus on providing a highly beneficial personal account option, as the reform plan does, and let workers voluntarily choose to forego the current Social Security benefits in favor of the much better personal account benefits and advantages. Then it doesn't matter what the specified benefits are under the old Social Security framework.

There would also be no change in Social Security disability benefits or in survivors' benefits for those who die before age 65. Those benefits would continue to be financed by the payroll tax and paid by the federal government as under current law. In Chile, those benefits were provided under the personal account structure through private life and disability insurance obtained through the personal accounts. But in the U.S. that is a reform step to be considered at some point in the future. Creating a personal account option for the retirement benefits alone is a big enough step for the U.S. political system to consider for now.

Married workers exercising the personal account option would contribute to a jointly owned account. In retirement, they would draw benefits together as a single-family unit. If the couple divorced, then the account funds at that point would be divided equally between the two spouses, into a separate account for each worker. They would then continue with those separate accounts into the future.

Transition Financing

Social Security operates primarily on a pay-as-you-go basis. The taxes paid into the system are not saved and invested to finance the future benefits of today's workers. Rather, those taxes are almost all immediately paid out to finance the current benefits of today's workers. The future benefits of today's workers are to be paid out of the taxes of future workers at the time.

Personal account reform involves a transition financing issue, because benefits to retirees must continue to be paid, while a large portion of the current payroll taxes that are supposed to finance those benefits under the pay-as-you-go Social Security system are being devoted to the savings and investment of the personal accounts. Consequently, the government must obtain substantial financing from somewhere else to continue to pay outstanding benefit obligations in full, until workers retiring in reliance on benefits from the personal accounts eliminate the net transition deficit.

Maintaining the Trust Funds. One immediate concern arising from this transition-financing burden is that as workers start devoting some of their payroll taxes to the personal accounts rather than the current Social Security framework, it will produce an immediate financial drain on the trust funds. The program will start running a net deficit sooner, requiring the trust funds to start to cash in some of their government bonds at an earlier date. The trust funds would also run out of those bonds and be depleted sooner as a result.

The government will have to devote general revenues to paying for the net transition deficit resulting from the reform. That is the only way currently promised benefits to current and future retirees could continue to be paid under the reform. Advocates of personal accounts have always noted that such transition financing from general revenues would be necessary.

As long as general revenues are going to cover any net transition deficit, then substantively it doesn't matter whether the arrival of Social Security deficits and depletion of the trust funds are accelerated. The same general revenues are going to cover the same net deficit and costs in any event. But, politically, a reform plan resulting in earlier net deficits and earlier trust fund depletion is vulnerable to demagoguery from opponents.

There is a simple way to avoid this vulnerability. Since the late 1930s, the government's policy has been that any annual surplus in Social Security is lent to the federal government to be used for other purposes, generally for other spending, sometimes to pay down the outstanding federal debt. The Social Security trust funds receive back federal bonds for these amounts that Social Security can use to obtain cash in the future when needed to pay promised benefits.

Similarly, under our proposed reform plan, for any Social Security payroll taxes used for personal accounts, bonds representing these amounts would be issued to the Social Security trust funds identical to the bonds that have historically been issued to the trust funds. Those bonds could again be turned in for cash whenever Social Security needed the money to pay promised benefits.

This means the personal account reform would not drain any money from the Social Security trust funds. It would not accelerate the date when the program starts to run a deficit, because payroll taxes would be counted as continuing to flow into the Social Security trust funds in full, before a portion of them are sent to the personal accounts in return for the bonds. Nor would the reform reduce the amount of bonds or assets the trust funds would hold under current law or accelerate the date at which the trust funds run out of bonds. The future course of the Social Security trust funds would remain the same as under current law, except that as people start to retire relying on personal accounts in place of some of the benefits from the old Social Security framework, the drain on the trust funds would actually be reduced, future Social Security deficits would be reduced, and the date at which the trust funds would be depleted would be pushed back.

Where the Money Comes From. Of course, these bonds issued to the trust funds are just a formal mechanism for devoting general revenues to Social Security to cover the transition deficits. But these bonds are not a source of such general revenues. The government would still need to determine where the general revenues would come from to cover the bonds when they are turned in to get the cash to pay promised Social Security benefits.

The precise sources of such funding have been discussed in great detail elsewhere. Peter Ferrara and Michael Tanner, *A New Deal for Social Security,* (Washington DC: Cato Institute, 1998), Chapter 9.

President Bush has already proposed to start with the annual Social Security surpluses. Increased tax revenues will also result from the wide range of taxes that will continue to apply to the investment income earned by businesses with the increased savings and investment from the personal accounts, even with the returns paid to the accounts themselves tax free. Higher revenues would also result from higher general economic growth from increased the saving and investment generated by the private accounts. The President can also decide in his budget each year to devote more resources to the transition obtained by reducing the growth in other expenditures.

Under the proposed reform plan here, the Office of Management and Budget would estimate the net deficit from the transition each year remaining after all these other factors are considered. The Congressional Budget Office and Congress would validate a final estimate of that number in its action on the budget. These funds would then be raised by issuing federal bonds in an off-budget account that would not be part of the rest of the federal operating budget, and not part of annual deficit or surplus calculations for that budget. In other words, by definition the net deficit impact due to the transition would be zero. Hunter and Conover have outlined the logic of using government debt to finance the transition to private Social Security accounts. Hunter, Lawrence A., and Conover, Steve, *Who's Afraid of the National Debt? The Virtues of Borrowing as a Tool of National Greatness*, IPI Policy Report #159, Institute for Policy Innovation, July 2001.

The bonds in this separate, off-budget account could then be retired over a period of 30 to 40 years. Over time, the net revenues from higher savings and investment and higher economic growth, and the savings to Social Security from workers relying on personal accounts should produce a net surplus from the reform that can be used to pay off these transition bonds. This would just help to spread out the transition-financing burden over future generations. Of course, in the future the government should follow whatever tax and fiscal policies are necessary to maximize economic growth at the time, which would also ultimately produce the strongest stream of tax revenues.

This off-budget approach is fully justified, as the off-budget account does not involve any new government spending or any new government debt. The bonds just explicitly recognize the implicit debt that already exists in the unfunded liability of Social Security, as Milton Friedman first argued many years ago. It would, in fact, be misleading to report a simple recognition of a former unrecognized debt as adding to the annual general budget deficit.

Indeed, if we count each year the portion of the unfunded liability of Social Security that was eliminated by the accounts for the year, there would be a net transition surplus each year rather than a net transition deficit. The transition is a one-time, non-recurring event that in the process eliminates a huge government debt in the form of the unfunded liability of Social Security, which is about three times as large as the reported national debt. How could it possibly make sense to report that debt elimination as adding to the deficit each year?

Assuming that almost all workers ultimately exercise the personal account option offered by the reform plan, over the long run, this process alone will eliminate Social Security's deficits and long-term financial problems, since workers will be relying for their retirement benefits on the personal accounts in place of the old Social Security benefits. The old Social Security framework and its deficits and financial problems will consequently be obviated. In the process, the unfunded liability of Social Security will be eliminated as well.

Policymakers who want to eliminate future Social Security deficits sooner by reducing the growth in Social Security benefits or by other means can advance proposals to do that separately from the personal account reform, if they wish. But it is important to differentiate between the personal accounts reform proposal, and proposals to accelerate Social Security deficits. These separate changes can then be debated and considered on their own merits.

Discussions of the transition often overlook the key fact that the reform eliminates the unfunded liability of Social Security over time. Those discussions consequently often contrast what are seen as the full costs of the transition with an inadequate appraisal of the benefits. But when the elimination of the unfunded liability is considered, the transition is more clearly seen as actually providing a net gain. Taking into account the unfunded liability helps us to recognize that there are costs to continuing with the status quo to be contrasted with the financial burden of the transition. The program's unfunded liability, in fact, now stands at $10.5 trillion, 2003 Annual Report of the Old Age and Survivors Insurance and Disability Insurance Trust Funds, March 17, 2003, Table IV.B8. three times the current reported national debt. The present value of the transition-financing burden under the reform plan will ultimately be substantially less than that.

This reform plan will likely promote economic growth resulting both from reduced taxes and higher savings and investment. That increased production and wealth naturally makes personal account reform the less expensive alternative, though we recognize the additional imperative of fundamental tax reform to stimulate further increased economic growth. Robbins, Aldona, *Social Security Reform and Tax Reform—Is One Possible Without the Other?* IPI Policy Report #172, Institute for Policy Innovation, February 2002.

The Benefits of Reform

The reform plan would provide enormous benefits for working people and the nation as a whole.

Personal Ownership and Control and Broader Freedom of Choice

First, the accounts would empower workers with personal ownership and control over their retirement funds. Workers would personally and directly own the funds in their individual accounts, like their own personal bank accounts. By contrast, the U.S. Supreme Court has explicitly held that workers have no property rights in Social Security. Congress retains the right to change, reduce or cut off benefits to any or all workers at any time. Fleming v. Nestor

With this personal ownership and control comes broad freedom of choice. Workers could choose among a wide range of investment alternatives managed by major investment firms and financial institutions. They could choose among different combinations of corporate stocks, corporate bonds, government bonds, bank certificates of deposit, mortgage pools, and others. These investment funds would all be fully diversified by highly sophisticated money managers at major investment firms.

This system for investing the accounts has worked quite well for even the most financially unsophisticated workers in other countries where personal accounts have been tried. Workers do not have to pick particular stocks, bonds or other investments, or decide when to buy and sell them. They just have to pick among investment funds sponsored and managed by major investment firms, regulated for safety and soundness.

The broader freedom of choice resulting from the accounts would extend as well to choice of retirement age, as workers could retire at any age after 59 �. Of course, workers would generally earn higher benefits from their investments the longer they waited to start drawing benefits. They would, in fact, gain the full advantage of market returns the longer they did wait, and would not suffer losses and financial discrimination for working past the standard Social Security retirement age, which occurs under the current Social Security program.

Workers would also be free to choose to leave substantial funds from their accounts to their children or other heirs. They would not lose everything they had paid in if they died just before retirement, or soon after retirement, as they currently do under Social Security, which offers only meager survivors' benefits that are quite difficult to qualify for. Over time, private accounts would allow low-income communities to have a much better opportunity to accumulate capital, offering the potential of a highly positive social revolution in America.

Of course, workers would be free to choose whether they want to participate in personal accounts. Those who don't believe in the personal accounts, for whatever reason, would be perfectly free to stay in the old Social Security system.

Higher Returns and Benefits

By exercising their freedom of choice in favor of the personal accounts, and saving and investing in real market capital, workers would receive much higher returns and benefits than what Social Security promises, let alone what it can actually pay. The long-term real rate of return on corporate stocks is around 7.5 percent to 8.0 percent, and on corporate bonds around 3 percent or more. Peter Ferrara and Michael Tanner, *A New Deal for Social Security,* (Washington DC: Cato Institute, 1998), pp 72-73.

With such long-term real returns, a conservative diversified portfolio with half of each would yield a real return of around 5 percent, after accounting for administrative costs. Administrative costs are likely to be less than 50 basis points, and possibly 20 points or less. See Peter J. Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington, DC: Cato Institute, 1998), pp. 88-89.

By contrast, even if Social Security somehow paid all of its promised benefits, for most of today's young workers the long term real rate of return they would receive from the current Social Security framework is around 1 percent or less. Peter J. Ferrara and Michael Tanner, *A New Deal for Social Security*, (Washington, DC: 1998), Chapter 4; William Beach and Gareth Davis, "Social Security's Rate of Return", Report of the Heritage Foundation Center for Data Analysis, no. 98-01, January 15, 1998; Peter J. Ferrara, "Social Security Rates of Return for Today's Young Workers" National Chamber Foundation, Washington, DC: 1986; Peter Ferrara and John Lott, "Social Security Rate of Return for Today's Young Workers," ed. Peter Ferrara, *Social Security: Prospects for Real Reform*, (Washington, DC, Cato Institute, 1983), pp. 13-36. For many it is zero or even negative. A negative return is like paying a bank to hold your savings deposit instead of receiving interest.

Even though under the reform proposal advanced here substantially less would be paid into the personal accounts than the tax payments required by Social Security, at standard market investment returns workers would get substantially more in benefits from the personal accounts than Social Security promises (but cannot pay due to its long term financing crisis). This would apply to workers across the board, at all income levels.

For example, let's take the case of an average income worker age 40 today who earns $35,000 per year. He entered the work force at age 23 earning $17,677 per year, and earns only the average annual salary increase each year. Suppose he was able to exercise the personal account option in our proposal from the start of his career. This year's payment into his account, at age 40, would be 10 percent of the first $10,000 in wages, and 5 percent of everything above that, for a total of $2,250.

Assume he invests each year in a diversified portfolio of half stocks and half bonds and earns standard market investment returns. We assumed for this calculation an average annual real return of 3 percent for bonds and only 7 percent for stocks, for an average annual real return of 5 percent on his entire portfolio.

The worker would reach retirement with a total accumulated trust fund of $334,095, in today's dollars after adjusting for inflation. That fund would be enough to pay an annual annuity about 70 percent more than what Social Security promises (but cannot pay), $2,653 per month compared to $1,567. With a higher percentage invested in stocks, the account would pay even more. With the account invested entirely in stocks and earning standard market investment returns, the worker would retire with a fund of $576,761, paying him $5,186 per month, again all in today's dollars. This would be well over three times what Social Security promises (but cannot pay).

Now take the example of an average-income two-earner couple, each 40 years old today. The husband earns an income of $40,000 this year, and the wife earns an income of $30,000, which is consistent with U.S. Census Bureau data regarding the average income of two-earner married couples. They again each entered the work force at age 23, with the husband earning $20,202 that year and the wife earning $15,152. They also each earn only the average salary increase each year. Suppose again that they exercised the personal account option described above from the start of their careers.

At standard market investment returns, with a diversified portfolio invested half in bonds and half in stocks, the couple would reach retirement with a total fund of $668,178, again in today's dollars after adjusting for inflation. That fund would be able to pay them about 60 percent more than what Social Security promises (but cannot pay), $4,987 per month compared to $3,133. Remember, this results from the contributions to the accounts of only 10 percent of the first $10,000 in wages and 5 percent of everything above that, compared with about 10 percentage points of the Social Security tax going to Social Security retirement benefits.

Moreover, with a higher percentage invested in stocks, again the account would pay more. With the account invested entirely in stocks, then at standard returns the couple would reach retirement with a fund of over $1 million ($1,153,188) in today's dollars. That fund would finance a monthly benefit of $9,840, more than three times what Social Security promises (but cannot pay).

Social Equity

Low-income workers would receive similar gains under our progressive proposal, even though the current Social Security benefit formula is skewed to favor low-income workers. Take the example of a worker age 40 who earns $20,000 this year. Assume he entered the work force at age 23 earning $10,101 that year. He also earns only average wage increases each year. Assume also that he is able to exercise our proposed personal account option from the start of his career.

At standard market investment returns, with a diversified portfolio half in bonds and half in stocks, he would reach retirement with a total fund of $223,282, in today's dollars. That fund would be able to pay him 64 percent more than Social Security promises (but cannot pay), $1,773 per month compared to $1,083. Investing more of the portfolio in stocks would earn even higher returns and benefits. With the account completely invested in stocks and earning standard market returns, the worker would reach retirement with a fund of $386,542 in today's dollars. That fund would pay him over three times what Social Security promises (but cannot pay), $3,476 per month compared to $1,013.

Moreover, such a career low-income worker would usually not be entering the work force at age 23, after college. Suppose we assume the worker enters the work force at age 19 earning $8,600 that year. With the additional funds from four years of early work at ages 19-22, and a portfolio of half bonds and half stocks earning standard returns, the worker would reach retirement with a trust fund of $271,505 in today's dollars. That fund would pay the worker 84 percent more than Social Security promises (but cannot pay), $2,156 per month compared to $1,172.

A higher proportion of stocks in the portfolio would again earn higher overall returns and benefits for this case as well. A fund invested entirely in stocks starting at age 19 would accumulate for this lifetime low-income worker to half a million dollars by retirement ($500,471), which would pay him close to four times what Social Security promises (but cannot pay).

Why Personal Account Benefits Are Better

Why this enormous gulf between what the personal accounts can pay and what Social Security can pay? The personal accounts operate as a fully funded system. The money paid in is saved and invested in new capital investments. These capital investments increase production, and the value of this production increase is returned to investors in the form of a rate of return or interest payment on their investments. Over the course of a lifetime, this return would accumulate to large sums, which would then be used to finance benefits in retirement.

But, as we have discussed, Social Security operates primarily on a pay-as-you-go basis, where the money paid in today is not saved and invested but is mostly immediately paid out to finance current benefits. The future benefits of today's workers are not to be paid by their savings and investment, but by the future taxes to be paid by future workers. Such a system adds nothing to production. It is a mere redistribution system, transferring funds from one segment of the population to another. This means that workers under such a system lose the full amount of the increased production and associated returns they would get if their money were invested in private, productive assets through a fully funded system. The payroll–tax-financed redistribution system can pay some effective return as revenues grow over time due to increased wages and population growth, enabling the system to pay more to retirees than just what they paid in. But this effective return, which is still obtained by a tax redistribution from others rather than increased production will never be anywhere near as great as the full returns produced by capital investment. For further discussion, see Peter J. Ferrara, *Social Security Rates of Return for Today's Young Workers* (Washington D.C.: National Chamber Foundation, 1986), pp. 8-11; Peter J. Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington .D.C.: Cato Institute, 1998), Chapter. 4

A Social Safety Net

Even though much higher benefits can be expected from the accounts than from the old Social Security framework, nevertheless the personal account system would be backed up by a social safety net guaranteeing that workers with the accounts would get at least what they would have gotten from the old Social Security framework. Such a safety net is feasible since the personal accounts are so likely to pay workers more than what Social Security promises today. This safety net would encourage increased adoption of the personal accounts without unnecessary fear or anxiety. It would also avoid any possibility of someone suffering due to an odd, unexpected circumstance. Every country that has adopted personal accounts has included a similar social safety net, and the U.S. should as well.

Social Equity for Minorities

The poor deal offered by Social Security applies with a vengeance to African-Americans, because they have much lower life expectancies than the general population. Consequently, they tend to live fewer years in retirement to collect benefits, and more frequently die before reaching retirement age. A black male born today has a life expectancy of 65.8 years, while the Social Security retirement age by then is already scheduled to be 67. Ferrara and Tanner, p. 101.

This means African-Americans on average receive even lower returns on the taxes they pay into the system. A widely noted 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. Beach and Davis, Table 1, p. 8. The return for an average income two-earner family with children was effectively 0 percent (0.15 percent). *Ibid.*

This problem would be addressed through the personal accounts. Workers who die before retirement or just after retirement would not lose everything they had paid into the system over the years. They would be able to leave the account funds they had accumulated to their children or other heirs. Moreover, as discussed, membership associations like the NAACP could offer annuities promising a monthly benefit for life tailored for their membership. Those annuities could then take account of the lower life expectancies in the African-American community, paying higher retirement benefits for the fewer years for the fewer retirement years they live on average. African-Americans consequently should be able to gain even more from personal accounts than others.

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 65, compared to 12 percent of the general population. Naomi Lopez Bauman, *Hispanic Americans' Growing Stake in Social Security Reform*, Heritage Foundation Backgrounder No. 1465, Aug. 22, 2001, p.1. Moreover, only about 30 percent of Hispanic Americans over 65 receive any retirement income from assets, compared to 68 percent of the general population. *Ibid.*, p.4. Clearly, Hispanic Americans are among those who would have the most to gain from a personal account option for Social Security.

Broader and More Equal Ownership

Personal accounts would also produce a broader and more equal ownership of wealth and capital. Through these accounts, below-average-income workers would enjoy their only real chance to participate in capital markets like higher income workers and accumulate substantial savings and capital. The top half of income earners is already accumulating substantial wealth ownership through 401(k)s, IRAs and other savings vehicles. But the bottom half of income earners do not earn enough to invest extensively. As a result, they are falling farther and farther behind. A recent study from the Federal Reserve Board reported that from 1998 to 2001 the difference in median net wealth between the wealthiest 10 percent of families and the poorest 20 percent jumped by nearly 70 percent. The difference between whites and African-Americans grew by 20 percent. In contrast, a study by Harvard Professor Martin Feldstein indicated that a personal account system would reduce the total concentration of wealth by one half. Martin Feldstein, "Social Security and the Distribution of Wealth," *Journal of the American Statistical Association,* (December 1976): 90-3.

The much wider ownership interest established through personal accounts would produce far-reaching and highly beneficial social consequences. Through the personal accounts, virtually every worker would directly own a substantial stake in America's business and industry. Workers across the board would see the value in economic policies that would maximize overall economic growth, to the more direct and transparent benefit of everyone.

Greatest Tax Cut in World History

Under this reform proposal, the payments into the personal accounts would be about one-third less than the current taxes for Social Security retirement benefits, which consume about 10 percentage points of the current payroll tax. Eventually, as the transition costs are brought under control, the current tax would be reduced to the mandatory payments into the accounts, for those who exercise the account option. Such a reduction in payroll taxes amounts to a payroll tax cut of about one-third, shared equally between future workers and employers.

But the reform plan ultimately involves an even bigger tax cut. The personal accounts would transform today's public Social Security taxes into private retirement payments by workers and employers into each worker's privately owned personal savings and investment account. The full scope of the current Social Security payroll tax now going to Social Security retirement benefits, about 10 percentage points of the current 12.4 percent Social Security payroll tax, would effectively no longer be public taxes. This would amount to the greatest tax cut in world history.

Moreover, the reduced tax burden and higher savings and investment resulting from personal accounts would substantially boost economic growth. The result of this is more jobs, better jobs, and higher wages and overall income.

Greatest Reduction in Government Debt in World History

Finally, the reform plan would ultimately eliminate Social Security's financing crisis entirely. The government's own reports now indicate that paying all promised Social Security benefits to young workers entering the work force today would require raising the Social Security payroll tax by 50 percent or more. This is due to the impending retirement of the baby boomers along with sharply decreased fertility since the early 1970s, along with increased longevity in retirement, and slower wage growth over the past 30 years. In Social Security's pay-as-you-go system, where today's benefits are financed by today's taxes, with no real savings and investment, these factors all translate into a yawning gap between incoming revenues and outgoing expenditures.

But because of the broad and powerful benefits of personal accounts for all workers, the vast majority of workers can be expected to exercise the personal account option, as occurred with a similar option in Chile (over 90 percent adoption). Over time, workers will be relying more and more on fully funded personal accounts and less and less on the older Social Security system and its deficits. Ultimately, we would reach the point where virtually all retirees are relying on personal accounts for their retirement benefits in place of the old Social Security framework. At that point, the old Social Security framework would bear little or no benefit obligations, and there would consequently be no major deficit of any significance for that older system to cover.

This will have been accomplished without any cut in Social Security benefits or (even worse) an increase in Social Security taxes, which would be very harmful to working people, particularly low-income workers and minorities. Indeed, over time, benefits will have been increased and effective taxes reduced through the personal accounts. That results because the savings and investment of the personal accounts, and the reduced taxes, increase overall production, income and wealth.

Moreover, as discussed above, any net transition deficit each year, after all other feasible resources to cover it have been tapped, would be financed by issuing government bonds in an off-budget account. Those bonds, which could be paid off over an extended period of 30 to 40 years, would just explicitly recognize the debt that already exists in the unfunded liability of Social Security. As a result, under this reform proposal, the net impact of the transition to personal accounts on the annual budget deficit is zero. We discussed above why this is the proper accounting for the transition, as it does not involve any real new government spending or any real new government debt. Politically, the only feasible means of achieving personal account reform is to get it out of the annual budget wrestling match.

In the process of eliminating the deficits of the current Social Security framework, personal accounts would also have eliminated completely the unfunded liabilities of Social Security. Now standing at $10.5 trillion, that unfunded liability is three times the reported national debt. Eliminating that liability would, in fact, be the greatest reduction in government debt in world history.

Conclusion

The proposed personal account reform would simply expand and modernize the current Social Security framework to bring into the system a central role for personal ownership and real, wealth-producing, savings and investment. But a social structure for ensuring retirement benefits and a social safety net would still exist, in a new framework providing great advantages for working people across the board, and lower-income workers and minorities in particular.

The personal accounts, in fact, would deliver on the original promise of Social Security. The accounts would restore what people originally thought Social Security was supposed to be: a means of saving for their retirement, along with their employer, in their own designated account. Indeed, it was only until recently that most people thought the government through Social Security held an individual account for each of them in which their contributions, along with the contributions of their employers, were accumulating. Despite the best efforts of the reformers to debunk that myth, it may still be widely believed.

Some reformers are now urging President Bush to use his political capital to push through a package of substantial long-term benefit cuts, along with a small personal account of roughly 2 percentage points. But that may well turn into a politically suicidal Charge of the Light Brigade for the president and his congressional allies, and not nearly achieve the true and full goals of reform in any event. Instead, the president should use his substantial clout to push through a complete and progressive personal account reform as described here, based on 5 percentage points of the payroll tax, along with a progressive doubling of that on the first $10,000 of wages. Such a reform would provide a complete option for all Social Security retirement benefits in one step, accomplishing the full scope of reform goals. It would in the process produce a sea change of economic benefits for working people, and a legacy of Rooseveltian proportions.

This proposal should be of equal interest to socially liberal policy makers. As we have shown, if the reform is done right, working people, low-income workers, and minorities have the most to gain.

About the Author

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He is a graduate of Harvard College and Harvard Law School, and has practiced law with firms on Wall Street and in Washington, DC. He wrote the first book for the Cato Institute providing a comprehensive intellectual foundation for a personal account option for Social Security, *Social Security: The Inherent Contradiction* (1980), and has continued to write on that concept in further books, studies and articles for Cato, the Heritage Foundation, the National Center for Policy Analysis, the Family Research Council, the U.S Chamber of Commerce, and a wide range of other institutions and publications.

About the IPI Center for Economic Growth

He called for private accounts for individual workers. Bush proposed giving younger workers the option of directing some of their Social Security tax payments into a personal account. Source: Courage and Consequence, by Karl Rove, p.404-407 , Mar 9, 2010. The idea, "progressive indexing," was proposed by a Democrat: Social Security benefits are small, but they do increase over time based on a formula that takes into account both inflation and an index that averages the national increase in wages. Progressive indexing keeps that formula for the bottom 30% of wage earners, but for top-tier earners calculate benefit increases using inflation only. Bush said he would consider raising the retirement age for Social Security benefits as a way to help extend the life of the ailing program. The AARP is coming out strong against private Social security investment accounts, saying they "will actually make the problem worse, not better." In January they plan to spend $50 million on an ad campaign opposing privatization. Kevin Drum of The Washington Monthly has also been awesome in pointing out that the common wisdom that Social Security is in trouble is just not true. posted by nathanrudy (116 comments total). So how do you define a government that largely rejects a progressive tax system in favor of the wealthy? Oh yeah, a source would be nice too. (OP - thanks floydd). posted by Boydrop at 12:19 PM on December 30, 2004. Underthe private accounts that the President has proposed, the cost of the accounts would be offset by reducing the Social Security benefits of those electing the accounts. For every dollar in payroll taxes that a worker diverted from Social Security to an account, the worker's Social Security benefits would be cut a dollar plus an interest charge equal to three percent above inflation. Thus, under the proposal to combine progressive price indexing with private accounts, Social Security benefits would be lowered twice— once due to the indexing changes, and a second time to pay for the private accounts Under the Administration's proposal for accounts within Social Security, workers receive payroll revenue today, but pay the payroll revenue back, plus interest at a 3 percent real rate, at retirement through a reduction in traditional Social Security benefits. In effect, the individual accounts represent a

“Social Security line of credit.” The recent “progressive price indexing” proposal involves surprisingly and excessively large benefit reductions for average workers. In addition, it reduces benefits more if productivity growth turns out to be higher than we currently expect, exactly the opposite of the appropriate response because the underlying 75-year actuarial deficit would be smaller with faster productivity growth. The last major assault on the program, George W. Bush’s 2005 proposal to replace Social Security by diverting revenues into private accounts, turned into a political train wreck when members of the president’s own party shunned his plan. The chief, indeed the only, argument for scaling back Social Security is that current Social Security taxes plus accumulated reserves are insufficient to pay all scheduled benefits beyond 2034, if current projections turn out to be exactly correct—or a few years earlier or later, if they are a bit off. A progressive agenda for Social Security reform should achieve three core goals. Second, it should restore the progressivity of Social Security that economic and demographic trends have eroded.