

# Social Security Reform Using

## Two Social Security debate the underlying privatization of the

IN FAVOR

BY HAEWORTH ROBERTSON

**S**OCIAL SECURITY BENEFIT PAYMENTS are projected to exceed Social Security payroll-tax income beginning in 2017, with the deficit growing larger each year thereafter. The nation is currently debating what to do about it.

Many people view this as a simple financing problem, a mathematics problem. They maintain that the system is basically sound and all we have to do is figure out a way to pay for it.

This is the wrong approach—a *Band-Aid* approach to cure a serious illness. We should examine the underlying reasons for Social Security's financing problems and design our solutions accordingly. Here are some of the root causes of the system's projected future deficits:

- Decreasing size of the workforce relative to the size of the retired population, caused by the high birth rates after World War II (baby boom) followed by a decrease in birth rates; increasing life expectancies; and decreasing retirement ages since World War II.
- The way in which the system is fi-

nanced, based on a pay-as-you-go system rather than an advance-funded system. This is the way Ponzi schemes and chain letters operate; they depend on ever-increasing numbers of new participants to finance ever-increasing numbers of beneficiaries. Inevitably, the growth in new participants will slow down and the system will fail—whether it be a Ponzi scheme or a pay-as-you-go Social Security system.

These factors pose challenges for the entire economy, not just for the Social Security system. For example, the increasingly smaller workforce, relative to the whole population, will have difficulty producing all the goods and services needed to sustain that population. To do so will require the more effective employment of our human resources over a longer period than is presently the case. And a population that does not save will not generate enough capital for continued technological development, nor will it permit the continuing education and training needed to develop our human resources.

**IN FAVOR** continues on page 24

# Voluntary Personal Accounts

**former  
chief actuaries  
principles behind partial  
Social Security program.**

BY DWIGHT K. BARTLETT III

OPPOSED

**P**RESIDENT GEORGE W. BUSH has made it clear that a high priority, perhaps the highest priority item in his economic agenda for his second term, will be Social Security reform. He seeks so-called partial privatization of the program. He would allow younger workers to redirect a portion of their FICA tax, perhaps 4 percent of their taxable wages, from the Old-Age, Survivors, and Disability Insurance (OASDI) trust funds into personal accounts, with a limited variety of investment options provided to the worker. The argument is that such accounts will, on average, earn a higher rate of return than the trust funds do, resulting in ultimately larger benefits than the present program can sustain. It would also provide low-income workers, who now find it impossible to save and invest, a sense of ownership in a portion of our economic pie.

No student of the present program argues that it's indefinitely sustainable at present tax and benefit levels. The actuarial projections of the program trustees indicate that the OASDI trust fund will

be exhausted by about 2041 and the tax income beyond that point will be sufficient to pay only about 73 percent of benefits. Perhaps more important, benefit outgo is expected to exceed tax revenues by 2017, with the result that the U.S. Treasury will have to begin redeeming the federal bonds held in the trust funds, presumably by the use of general revenues or increased federal deficits.

Some critics of the partial privatization proposal argue that it's administratively unfeasible. For many low-income workers, who episodically leave and re-enter the workforce, the bookkeeping for their small accounts would be inordinately difficult and expensive.

Others argue that the massive amounts of employee contributions entering the securities markets would make the markets subject to undesirable political influences and result in unconscionable windfall profits for the managers of the investment funds offered as options to participating workers. Supporters of partial privatization

**OPPOSED** continues on page 26



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## IN FAVOR

To devise a solution to Social Security's problems, it is not enough to identify what caused things to go wrong. One must have a clearly articulated philosophy about social and economic goals against which to measure proposed changes. For example, to what extent should a nation's citizens have freedom of choice instead of having their activities limited or regulated? A free-enterprise, capitalistic society will answer such questions one way; a socialist society will answer them another way. Here is a set of principles that many Americans would endorse:

- An individual should have freedom of choice to the fullest extent possible, consistent with the interest of the nation as a whole.

- An individual should be afforded maximum opportunity and incentive to develop and use his abilities throughout his lifetime.

- A government (federal, state, or local) should provide those benefits, and only those benefits, that an individual (acting alone or as part of a group of individuals using some form of voluntary pooling or risk-sharing arrangement) cannot provide for himself. In meeting this responsibility, the government should become involved to the least extent possible, consistent with the interest of the nation as a whole.

Based on the factors and principles just mentioned, one logical solution to the nation's future economic problems, as well as Social Security's financing problems, would have the following characteristics:

- The nation's workforce should become more productive, requiring later retirement ages, increased saving and investment to finance technological development, and continuing education and training to accommodate the ever-changing job requirements.

- The Social Security system should be revised so that it provides a Tier 1 subsistence level of benefits that is financed on a pay-as-you-go basis; and a Tier 2 level of benefits of voluntary individual personal accounts that is ad-

vance funded.


To make the transition to such a two-tiered Social Security system from the present system would require certain reductions and revisions in benefits currently provided, including an increase in the average retirement age, as well as the addition of a properly designed system of voluntary individual personal accounts. A pay-as-you-go financing mechanism for Tier 1 benefits is feasible if the retirement age is set at an appropriate level and is adjusted upward from time to time, as life expectancy increases.

Personal accounts, taken alone, will not reduce the overall cost of the Social Security system, at least in the near term. But personal accounts have many other characteristics. They would reduce the role of government in determining retirement ages and incomes, and improve government accounting of revenues and spending obligations. They would result in more saving and investment, and any "surplus" Social Security taxes, raised in the name of retirement, would actually be used to fund retirement benefits, not be spent on other government programs as they are now.

Personal accounts would not redistribute income or create a dependence on the political system. Instead, they would create a huge new investor class that would have a stake in the future of the country. They would move us away from dependency on government and toward greater power and responsibility for individuals.

Opponents of personal accounts levy all sorts of charges against such accounts. They call it "privatization" to connote that personal funded accounts are somehow less respectable than unfunded government promises to levy future taxes. They complain about possible high administrative costs of maintaining such accounts. They warn of exorbitant investment management fees that will enrich "Wall Street fat cats." They worry about an extreme stock market collapse just before retirement, or a spendthrift

**IN FAVOR** continues on page 28



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## OPPOSED

dismiss such arguments, pointing out that the savings program offered to federal employees has many of the same characteristics as the personal accounts proposed and has operated successfully for more than a decade.

Another criticism of partial privatization is that, even if investments in private securities may provide higher average rates of return than the federal bonds held in trust funds, they expose the holders of the private accounts invested in these securities to unacceptable levels of market risk. People retiring at the time of a down market and annuitizing their private account balances may find their resulting annuity income severely compromised.

While I generally share the foregoing concerns, my main reasons for opposing private accounts are much more fundamental. As useful as the accounting for the OASDI trust funds is for informing the public about the costs of Social Security, it tends to obscure what really determines the long-term economic supportability of the program. Almost all the benefits paid by the program are spent immediately by the beneficiaries to support their consumption needs. The greater the aggregate benefits to all beneficiaries at any point in time, the larger their consumption. That consumption, in macro economic terms, is supported by our gross domestic product (GDP).

Currently, OASDI benefits represent about 4.3 percent of GDP. Current actuarial projections indicate that when the baby boom generation is fully retired in 2035, that ratio may be as much as 6.6 percent. Arguably, that's more than sustainable, given other federal commitments such as Medicare. Unless benefits are reduced in the future by some means, such as raising the retirement age, taxing benefits more fully, reducing the inflation indexing of benefits, etc., the projected benefits under current law can be made more affordable only if our economy grows faster than it otherwise would.

The wisdom of classical economics is that our economy's rate of growth

correlates closely with our national savings rate; more savings leads to a larger economy. This forces the conclusion that the partial privatization scheme would, assuming no reduction in aggregate benefits would occur, make Social Security more affordable only if it leads to a reduction in the current consumption and an increase in aggregate current savings. It's naïve in the extreme to believe that simply because younger workers will have the opportunity to divert a portion of their FICA taxes to individual accounts, they will, on average, reduce their consumption and increase their savings rate. In fact, they may actually reduce their savings in other forms, such as contributions to individual retirement accounts and 401(k) plans, thereby increasing their consumption.

Another troubling aspect of the proposal is that it would weaken the bias in the present benefit formulas toward lower-wage workers. The present plan benefit formulas result in a higher ratio of benefits to average lifetime wages for lower earners than for higher earners. If, under the proposal, every worker contributes 4 percent of his covered wages to his individual account, then everything else being equal, low-wage and high-wage earners will receive benefits that have the same ratio to their contributions into their personal accounts, and thus their wage histories. There will be no bias in favor of low-wage earners. The remaining portion of the traditional Social Security program will not have sufficient resources left to compensate for the loss of this part of the bias in the present formulas.

Thus, I conclude that the proposed personal account scheme not only will not make Social Security, our most prized social welfare program, more affordable, but it will also damage its ability to carry out one of its underlying objectives of providing greater protection against poverty in old age for lower-wage earners.

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## IN FAVOR

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or inept retiree who wastes his nest egg before his life is over. All of these possibilities would be guarded against by a properly designed system.

Opponents of personal accounts also allege that there will be trillions of dollars of transition costs in moving from one system to another. There is no "transition cost" associated with a shift from the present Social Security system to a revised system. If benefits under a revised system are no larger than benefits under the present system, the revised system cannot possibly cost more. There is no increase in liability for benefits earned in the past, only the explicit acknowledgment of a liability that already exists but was ignored in the past. This seems obvious.

Under the present system, to pay benefits in a given year, the money must be borrowed from payroll taxes paid that year. Under a revised system, if some of those payroll taxes are placed in a personal account and invested, they're not available to be borrowed. Therefore, the system must borrow from someone else—from the outside. The same amount of borrowing takes place, but the lender is different. When the system borrows from outside, it shows up as explicit national debt; but it doesn't when the system borrows payroll taxes, even though there's an implicit debt to the participant to provide future benefits. Re-labeling debt doesn't create transition costs.

It should be noted that between now and the year 2017, when Social Security payroll taxes exceed benefit payments, the resulting "surplus" is available for the government to borrow and spend as it desires. If personal accounts were implemented, this surplus of more than a trillion dollars would no longer be available for the government to borrow and spend. This would require additional government borrowing from the outside in order to continue its normal operations. But just because Social Security taxpayers quit providing funds for the government's operating expenses doesn't justify saying it creates a transition cost.

Another roadblock put up to stop Social Security reform is to claim that the system doesn't have immediate financial

problems. This position is usually based on the idea that the trust fund will enable the system to continue paying benefits until the year 2041—false reasoning caused by a misunderstanding of the nature of the trust fund. The Treasury bonds in the trust fund are merely the authorization for the government to collect more general taxes or borrow more money to repay Social Security the amount the government borrowed and spent for other purposes. But since the government is currently operating at a deficit, this means it's already unable to collect enough general taxes to operate. Thus, the added burden of collecting even more taxes to redeem the bonds held by the trust fund may be unbearable.

This *don't worry, be happy* contingent quotes all kinds of figures in an attempt to minimize Social Security's financial problem. They say the financing shortfall is, at most, 0.7 percent of gross domestic product over the next 75 years; or that it would solve the financing problem if we just raised payroll taxes by 2 percent. This technique takes gigantic deficits in the years ahead and averages them over 75 years to make them appear inconsequential, so that no action seems necessary. We all know the story about the man who drowned crossing a river whose average depth was only two feet.

Alan Greenspan, chairman of the Federal Reserve, told Congress on March 2, 2005: "I fear that we may have already committed more fiscal resources to the baby boom generation in its retirement years than our economy has the capacity to deliver." This is a powerful statement from a man who measures his words carefully.

The weaknesses of the Social Security system have been chronicled for many years. Isn't it time to confront these weaknesses and design a system whose financial status does not have to be constantly debated—a system that the majority of the citizens can understand and perceive as fair and reasonable? ●

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