

Testimony of

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I would like to begin by thanking the commission for their willingness to tackle this controversial and difficult issue. It is an unfortunate statement about current political life that you have been so unjustly vilified for simply speaking the truth about the need to rethink and reform our national retirement system.

The Cato Institute's position on the need for Social Security reform is well known. For more than 20 years, we have attempted to educate the public on the need to transform Social Security from a Pay-As-You-Go program to one based on real savings and investment. All of you have been provided with a wide variety of the research we have conducted over those two decades. Therefore, rather than simply reiterate points that have been repeatedly made by others, I would like to use this opportunity to set out some principles that I hope will guide you as you develop a final proposal for reform.

They are:

1) Solvency Is Not Enough: Workers deserve the best possible deal for their dollar. With Social Security facing a financial crisis—it will begin running a deficit in just 15 years—much attention has been focused on ways to keep the program solvent. Theoretically, that could be accomplished by raising taxes or cutting benefits. But Social Security faces a second crisis as well: Young workers will receive a negative rate of return from the program. They will get less back in benefits than they pay in taxes. That low return, and other inequities, is particularly disadvantageous to women, the poor, and minorities. Any Social Security reform must reverse this trend, raising the rate of return and providing higher retirement benefits.

2) Individuals, Not Government, Should Invest: The only way to increase Social Security's rate of return is to invest Social Security taxes in real capital assets. This should be done through the creation of individually owned accounts, not by allowing government to directly invest payroll taxes. Individual accounts would give workers ownership of and control over their retirement funds, allowing them to accumulate wealth and pass that wealth onto their heirs; it would also give them a greater stake in the American economic system. Government investment would allow the federal government to become the largest shareholder in every American company,

posing the potential threat to corporate governance and the specter of social investing.

3) Maximize Consumer Choice: Workers should be given as wide a range of investment opportunities as possible, consistent with regulatory safeguards against fraud or speculation. While investing in “Singapore derivatives” or your brother-in-law’s South American gold mining stock is clearly not envisioned, there is no reason to limit workers to only two or three index funds. As much as possible, the existing retirement savings infrastructure should be used, meaning workers would have a large number of safe and secure options.

4) Don’t Touch Grandma’s Check: Benefits to currently retired and nearly retired should not be reduced. Indeed, by explicitly recognizing benefits owed to current retirees, privatization would guarantee those benefits in a way that the current political system does not. Making the transition to a new system while guaranteeing current benefits means that the government will have to issue debt, cut current spending, or sell assets, but those “transition costs” will be substantially less than the costs of maintaining the current system.

5) More Privatization Is Better Than Less: You don’t cut out half a cancer. Given the advantages of a privatized Social Security system, there is no excuse for stopping at the privatization of only 2-3 percent of payroll taxes. Once the commission has conceded that private capital investment can provide better and more secure retirement benefits, it should press on allow workers to control the maximum feasible amount of their retirement income.

Let’s take a look at each of these points in a bit more detail:

Solvency Is Not Enough

The commission has been forthright in pointing out the irrefutable fact that Social Security faces irresistible demographic and fiscal pressures that threaten the future retirement security of today’s young workers. By 2016, just 15 years from now, the Social Security system will begin to run a deficit. That is, it will begin to spend more on benefits than it brings in through taxes. Anyone who has ever run a business—or balanced a checkbook—understands that when you

are spending more than you are bringing in, something has to give: you need to start earning more or spending less to keep things balanced. For Social Security, that means higher taxes or lower benefits.

In theory, Social Security is supposed to continue paying benefits after 2016 by drawing on the Social Security Trust Fund. The trust fund is supposed to provide enough money to guarantee benefits until 2038, when it will be exhausted. But one of Washington's dirty little secrets is that there really isn't a trust fund. The government spent that money long ago to finance general government spending and hide the true size of the federal budget deficit. The trust fund now consists only of IOUs—promises that at some time in the future the government will replace that money, which can only be accomplished by collecting more taxes or issuing even more debt.

Even if Congress can find a way to redeem the bonds, the trust fund surplus will be completely exhausted by 2038. At that point, Social Security will have to rely solely on revenue from the payroll tax. But that revenue will not be sufficient to pay all promised benefits.

As a result, the federal government will face a limited number of very painful choices--dramatically raise taxes, cut benefits, run huge deficits, or reduce other government spending.

However, as bad as this fiscal crisis is, it is crucial that the commission realize that it is not the only problem facing Social Security.

Even if Social Security did somehow manage to pay all of its promised benefits, today's young workers would be getting a bad deal. Workers born after 1973 will receive rates of return on their taxes ranging from 3.7 percent for a low-wage, single-income couple to just 0.4 percent for a high-wage single male. Studies show that investing those tax funds in private savings and insurance would likely yield three or more times the benefits Social Security promises to today's young workers.

If taxes are raised or benefits cut to solve the bankruptcy problem, Social Security will become an even worse deal for today's young workers. On the other hand, if taxes are cut or benefits raised, the system's financial crisis will worsen. The only way to solve both problems is to turn to the private sector, where the high returns and

new income generated by private investments will fully finance better benefits than those promised by Social Security.

The current Social Security system also entails costs for the economy at large. It displaces private alternatives under which the funds coming in would be saved and invested for the future benefits of today's workers. The result is a large net loss of national savings, which reduces capital investment, wages, national income, and economic growth. Moreover, by increasing the cost of hiring workers, the payroll tax substantially reduces wages, employment, and economic growth as well.

A shift to a private system, with hundreds of billions of dollars being invested in individual retirement accounts each year, would likely produce a large net increase in national savings, depending on how the government financed the transition. This would increase national investment, productivity, wages, jobs, and economic growth. Replacing the payroll tax with private retirement contributions would also improve economic growth, because the required contributions would be lower and those contributions would be seen as part of a worker's direct compensation, stimulating more employment and output.

Harvard economist Martin Feldstein estimates that privatization of Social Security would produce \$10 trillion to \$20 trillion in present value net benefits to America. That is essentially his estimate of the present value of the improved economic performance that would result from the reform. Most of that net benefit would probably come in the form of the higher returns and benefits earned for retirees through private investment accounts. But some would come in the form of higher wages and employment for working people.

While nearly all young workers receive a bad deal from the current Social Security system, low-income workers and minorities may be among those who lose the most.

Elderly African Americans are much more likely than their white counterparts to be dependent on Social Security benefits for most or all of their retirement income, yet the current system often works to their disadvantage.

Despite a progressive benefit structure, Social Security benefits are inadequate to provide for the retirement needs of the elderly poor, leaving nearly 30 percent of African-American seniors in poverty. Moreover, because African Americans generally have shorter life

expectancies than do whites, they receive less total Social Security payments over the course of their lifetimes.

Social Security also contributes to the growing wealth gap between blacks and whites. Because Social Security taxes squeeze out other forms of saving and investment, especially for low-income workers, many African Americans are unable to accumulate real wealth. And, since Social Security benefits are not inheritable, that wealth inequity is compounded from generation to generation.

Traditional Social Security reforms such as raising the retirement age, cutting benefits, or increasing taxes would only make the problem worse. On the other hand, African Americans would be among those with the most to gain from the privatization of Social Security—transforming the program into a system of individually owned, privately invested accounts.

In addition, low-income workers generally would be among the biggest winners under a private system. The higher returns and benefits of a private, invested system would be most important to low-income families, as they are in greater need of the extra funds. The funds saved in the individual retirement accounts, which could be left to the children of the poor, would also greatly help families break out of the cycle of poverty. Similarly, the improved economic growth, higher wages, and increased jobs that would result from privatization would be most important to the poor. Moreover, without reform, low-income workers will be hurt the most by the higher taxes or reduced benefits that will be necessary if we continue on our current course.

Moreover, with average- and low-wage workers accumulating large sums in their own investment accounts, the distribution of wealth throughout society would become far broader than it is today. That would occur, not through the redistribution of existing wealth, but through the creation of new wealth, far more equally held. Because privatizing Social Security would turn every worker into a stockowner, the old, senseless division between labor and capital would erode. Every laborer would become a capitalist. The socialist dream of the nation's workers owning its businesses and industries would be effectively achieved. At the same time, as the nation's workers became capitalists, support for free-market, pro-growth economic policies would increase in all sectors of society. That social effect is one of the least cited but most important reasons for privatizing Social Security.

After all the economic analysis, however, perhaps the single most important reason for privatizing Social Security is that it would give American workers true ownership of and control over their retirement benefits.

Many Americans believe that Social Security is an “earned right.” That is, because they have paid Social Security taxes they are entitled to receive Social Security benefits. The government encourages this belief by referring to Social Security taxes as “contributions,” as in the Federal Insurance Contributions Act, or FICA. However, the U.S. Supreme Court has ruled, in the case of *Flemming v. Nestor*, that workers have no legally binding contractual or property right to their Social Security benefits, and those benefits can be changed, cut, or even taken away at any time.

As the Court stated, “To engraft upon Social Security a concept of ‘accrued property rights’ would deprive it of the flexibility and boldness in adjustment to ever changing conditions which it demands.” That decision built on a previous case, *Helvering v. Davis*, in which the Court had ruled that Social Security is not a contributory insurance program, stating that “the proceeds of both the employer and employee taxes are to be paid into the Treasury like any other internal revenue generally, and are not earmarked in any way.”

In effect, Social Security turns older Americans into supplicants, dependent on the political process for their retirement benefits. If they work hard, play by the rules, and pay Social Security taxes their entire lives, they earn the privilege of going hat in hand to the government and hoping that politicians decide to give them some money for retirement.

In contrast, under a privatized Social Security system, workers would have full property rights in their private accounts. They would own their accounts and the money in them the same way they own their individual retirement accounts (IRAs) or 401(k) plans. Their retirement benefits would not depend on the whims of politicians.

Individuals, Not Government, Should Invest:

Supporters of government investing claim that it would allow the government to reap the benefits of the higher returns available in private capital markets, incur lower administrative costs than

individual accounts, and allow the government to spread the risk of poor investment performance.

On the surface, that approach may have some appeal; in reality it is fraught with peril. It could potentially make the federal government the largest shareholder in American corporations, raising the possibility of government control of American business. In addition, there are serious questions about what types of investment the government would make. Political considerations and "social investing" are likely to influence the government's investment decisions, allowing the government to manipulate economic markets.

The investment practices of state, county, and municipal pension programs provide a useful illustration. Fully 44 percent of such funds operate under investment mandates, such as requirements that they invest in in-state industries, affordable housing, or renewable energy. An additional 25 percent face investment restrictions, such as prohibitions on investing in tobacco stocks or companies doing business in certain countries. In addition, state pension funds have occasionally used their voting power to interfere in corporate governing decisions.

Public pension funds are able to operate in this way because workers have no ownership or property rights in their retirement funds. They are merely one of many "stakeholders" in the funds. When workers have property rights, there is a fiduciary duty to operate the funds in the best interest of the fund owner. However, with state, county, and municipal pension funds, state and local governments are free to balance the interests of various stakeholders, including society at large. They are free, therefore to politicize investment decisions, if they feel their decisions are best for society, even if those decisions lead to lower returns or otherwise harm retirees.

It is also important to note that the World Bank has examined government investments around the world and found that a) they are highly politicized, and b) almost universally earn rates of return below private sector investments.

Given the potential for economic mischief, it would be a monumental mistake to allow the federal government to directly invest Social Security funds.

Maximize Consumer Choice

While the Federal Thrift Savings Program provides a useful model for a system of individual accounts, it may be too restrictive in the choices of investment options that it offers. While certainly any system of individual accounts will have some restrictions to prevent unacceptable levels of speculation and to reduce initial administrative costs, every effort should be made to give workers as much freedom of choice as possible while maintaining basic consumer protections. Indeed, excessive government direction of investments may actually increase the risk to investors.

The recent experience of the Canadian Pension Plan offers a cautionary example (a warning against government investment as well). The CPP Investment Board was mandated by law to invest at least 35 percent of its assets in a portfolio that tracks the Toronto Stock Exchange 300 composite index. When Nortel shares rose higher than \$120 last summer, it came to dominate the TSE 300 -- and the CPP board's portfolio. By August 2000, 28% of the board's assets were in Nortel stock. When the stock's price began to collapse this year, the board was unable to protect itself by selling. Forced by government fiat to hold a falling asset, the CPP lost \$852 million.

Moreover, forcing large amounts of investment into specific index funds poses the risk of seriously distorting capital markets. Ideally, capital should be free to move to wherever investors feel that it would be used most efficiently and produce the best returns. To the degree government restrictions allocate capital through other than market methods, the efficiency of that allocation will be undermined.

It seems likely, however, that the commission will include substantial initial limits on investment, designed to minimize both risk to unsophisticated investors and administrative costs. Therefore, I would urge the commission to give serious consideration to options that would allow workers to expand their investment options once workers have accumulated a reasonable level of assets in their accounts. In particular, I call to the commission's attention work by William Shipman of State Street Global Advisors suggesting such a multi-tiered system.

Don't Touch Grandma's Check

This principle should be self-evident and coincides with the president's mandate that any reform proposed by the commission should not change the benefits of retirees or near retirees. This undoubtedly means that General Revenues will be required to ensure current benefits while allowing younger workers to divert a portion of their payroll taxes to individual accounts. This may well cause a certain amount of pain for the politicians who will be unable to use that money for their pet pork barrel projects or corporate welfare. However, it is important to recognize that while the transition to a system of individual accounts may move costs forward in time, it actually reduces those costs over the long-term. In short, paying some today, will prevent paying far more tomorrow.

In addition, while the focus is rightfully on preventing benefit cuts for current or near retirees, I would urge the commission to go farther and ensure that younger workers will also receive a combination of benefits, split between individual accounts and government benefits, that is as high or higher than benefits today. Clearly, if system solvency is to be maintained, a disproportionate reduction in the government-provided benefits will be required beyond that necessary to offset the amount of diverted payroll taxes. However, for retirees, what counts is not the mix between government benefits and benefits from individual accounts, but total benefits. Given the far higher returns from private investment, I believe it is possible to devise a system under which the total benefits received by future workers will be substantially higher than today.

One key to such a system is to ensure that individual accounts are large enough to allow a substantial accumulation of wealth, which brings us to the final principle:

More Privatization is Better Than Less

It is no secret that my personal preference would be for the "Full Monty," allowing workers to have ownership and control over all their payroll taxes. However, I recognize that the commission is unlikely to choose that option. Even so, I would urge the commission

to go beyond the two percentage points commonly discussed and allow the maximum amount of privatization possible.

This is especially important for low-income workers. If one of the goals of Social Security reform is to allow low-wage workers to accumulate wealth, it is easy to see that very small accounts provide a limited opportunity for such wealth accumulation. Take, for example, the case of a single male, age 30, earning 20,000 per year. A two percentage point account invested in a mixed fund (60 percent stocks/40 percent bonds) and earning historic rates of return will allow him to accumulate just over \$43,000 by retirement, certainly better than nothing, but not substantial wealth. A four percentage point account, however, would give him nearly \$87,000, while allowing him to invest the entire “employee” portion of his payroll tax (6.2 percentage points) would allow him to accumulate more than \$130,000.

Second, while claims about administrative costs and the difficulties of administering individual accounts have been significantly exaggerated by critics of privatization, there is no doubt that larger accounts are less costly and easier to administer than small ones.

Third, given the higher rates of return available from private investment, it makes little sense to allow workers to take advantage of those returns with only a very small portion of their payroll taxes. If the current Social Security system is flawed, it makes sense to move as much as possible of payroll taxes to a non-flawed system.

Finally, if the commission believes that an increase in national savings is at the heart of any effort to reform Social Security, larger individual accounts will provide a greater increase in national savings than smaller accounts. After all, if a small increase in national savings is good, wouldn't a large increase be better?

My preference would be for larger individual accounts across the board. However, if this is not possible, at least low-wage workers should be given the largest possible accounts. This can be done in two ways. You could adopt a sliding scale for contributions to individual accounts—say, 8 percent of the first \$20,000, 4 percent of the next \$20,000, and 2 percent above that, or something similar. Or contributions could be allowed up to a specific flat dollar amount, say \$1,200 per year.

Conclusion

In the wake of September 11, it may seem hard to get excited about something as mundane as reforming Social Security. Yet, the problems facing Social Security have not changed. Prior to September 11, Americans understood that the nation's retirement program was financially unsustainable, provided a poor and deteriorating rate-of-return for young workers, treated working women and minorities unfairly, and gave workers no ownership or control over their retirement income. All those things remain true after September 11.

Everything I have seen to date, indicates that this commission is on the right track to ensuring a safer and more secure retirement for future generations of American workers. I appreciate this opportunity to provide my input, and urge you to press on.

Thank you.