Senate Democratic Policy Committee Hearing

"An Oversight Hearing on the Bush Administration's Plans to Privatize Social Security"

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January 28, 2005

Mr. Chairman, Senators,

It is a both a privilege and an honor to be invited to appear today and offer my views on the need for fundamental reform of the American Social Security system.

Let me say at the outset, Social Security reform should be a bipartisan issue. In many ways, Social Security is a creation of the Democratic Party. And, more recently many Democrats have been willing to speak out on the need for reforming and modernizing the program. As long ago as 1998, then-President Bill Clinton was warning that, "Today Social Security is sound, but a demographic crisis looms if we fail to act. For over the next 30 years, 76 million baby boomers will retire. By 2030 there will be twice as many elderly Americans as there are today. If we don't act now, by then payroll contributions will only cover 75 percent of benefits."

Others, including your former colleagues Bob Kerrey, Charles Robb, John Breaux, and, of course, Daniel Patrick Moynihan, as well as Congressmen like Tim Penny, Charlie Stenholm, and Harold Ford, not only recognized the urgent need for reform, but embraced the idea that reform could be an opportunity to build a newer, better Social Security reform that gave workers ownership and control over their retirement income, while allowing workers — especially low- and middle-income workers — to accumulate real, inheritable wealth, in short individual accounts.

You have invited me hear today specifically to discuss the impact of Social Security reform on seniors' benefits. I am presuming that you are concerned with benefits of seniors in the future, the benefits of those who are currently working but will, obviously, someday retire, since the President has made it clear that he will not support any Social Security reform proposal that reduces benefits for current seniors. This principle is reflected in the major individual account bills that have been introduced in the last session of Congress, and so far in this session. They would explicitly leave the benefits of current seniors untouched. Indeed, they would not even give the option of individual accounts to those nearing retirement; their benefits would also remain exactly as currently scheduled.

However, most individual account proposals, and indeed most Social Security reform proposals regardless of whether they include individual accounts would have an impact on the future benefits of today's younger workers. Yet, it is important that any such discussion must take place in the context of Social Security finances. That is because, given Social Security's finances, comparing *any* reformed Social Security system to the currently promised benefits is to compare reality to a fantasy. That is because, given current revenues, promised future benefits simply cannot be paid.

We can become forever embroiled in semantic debates over what does or does not constitute a "crisis." However, we cannot deny the fundamental facts.

Social Security will begin running a deficit in less than 15 years — that is, it will begin to spend more money on benefits that it brings in through taxes. At that point, in order to continue to pay promised benefits, it will have to draw on the Social Security Trust Fund. Opponents of reform have made much of the Trust Fund recently, suggesting that it guarantees Social Security's solvency until 2042, or even 2052 according to some projections. However, as Congressional Budget Office director Douglas Holtz-Eakin has noted "[The Trust Fund] has no real economic resources … The key moments for Social Security are in 2018. Cash-flow benefits will equal cash-flow payroll taxes, and then after that, the Social Security Administration will have to come back to the rest of the budget for additional resources to pay promised benefits."

Or to cite a source that might be even more significant to this committee, President Clinton's FY2000 budget, which states "These Trust Fund balances are available to finance future benefit payments…but only in a bookkeeping sense … They do not consist of real economic assets that can be drawn down in the future to fund benefits. Instead, they are claims on the Treasury that, when redeemed, will have to be financed by raising taxes, borrowing from the public, or reducing benefits or other expenditures. The existence of Trust Fund balances, therefore, does not by itself have any impact on the government's ability to pay benefits."

This is not to say that the Federal government will default on the bonds in the Trust Fund. I am not doubting the "full faith and credit" of the U.S. government. However, that does not relieve the Federal government from the obligation to find the money with which to redeem those bonds, currently $1.5 trillion in present value terms. To put it in perspective, think of it this way. In 2019, the first year after Social Security begins running a deficit, the shortfall will be roughly as much as the Federal government spends on such programs as Head Start and the WIC program. The cost rises rapidly thereafter. By roughly 2023, the cost of redeeming enough Trust Fund bonds to pay all the promised Social Security benefits would be nearly as much as the cost of funding the Departments of Interior, Commerce, Education, and the Environmental Protection Agency. By 2038, well before the theoretical exhaustion of the Trust Fund, you can add the Departments of Veterans Affairs, Energy, Housing and Urban Development, Justice; NASA; and the National Science Foundation. Simply redeeming the Trust Fund will begin to squeeze out all other domestic spending priorities.

Beyond 2042, once the Trust Fund is exhausted, the deterioration in Social Security's finances only increases — and never gets any better. Overall, the present value of Social

Security's unfunded obligations runs to nearly $12 trillion (approximately $1.5 trillion to redeem the Trust Fund and $10.4 trillion in unfunded benefits thereafter).[1]

Quite simply, Social Security cannot pay the promised level of Social Security benefits with its current level of revenues. Therefore, it is improper to compare benefits under a reformed Social Security system with today's promised level of benefits. Those promises are simply a fantasy. In fact, by law, Social Security will have to reduce its benefits by approximately 27 percent, once it is unable to fund those benefits. This will occur regardless of whether individual accounts are created or not. As former Senator Bob Kerrey has said, doing nothing is the same as a 27 percent benefit cut.

Given the fact that the Federal government is not likely to wait until that day and simply allow benefits to suddenly drop 27 percent, there are several ways to create a smoother path to bringing benefits into line with revenues. I believe that the best of these is to change the benefit formula from a wage-indexed basis to a price-indexed one.

Currently the formula for determining initial Social Security benefits is adjusted to reflect national wage growth. Because wages generally grow faster than prices, each year's retirees receive higher benefits (after adjusting for inflation) than those retiring the year before. The White House is reportedly considering changing the formula so that it is adjusted by prices or inflation instead. This means that every group of retirees would receive the same initial benefits as previous retirees, adjusted for inflation, but not the benefit increases above inflation that are currently promised.

In looking at this proposal, here are some important things to keep in mind:

- No future retiree would receive less than those retiring today adjusted for inflation. Only in Washington is the reduction in the rate of increase considered a cut.
- Building ever-increasing benefits into a system that is facing $12 trillion in unfunded liabilities is simply irresponsible.
- The change will not affect benefits of anyone currently retired or near retirement. All of the plans under consideration would phase price-indexing in over 35 or

[1] Social Security's financial problems are not the only, or in my opinion, even the most important reason to reform the system. If it was — if maintaining Social Security's solvency was the only concern — it is possible to do so by raising taxes or cutting benefits. That is, for example, what Dr. Orszag proposes.

However, there are other issues — and opportunities — that we should consider. For example, it is important to remember, that Social Security taxes are already so high that younger workers will receive an extremely poor, and far below market, rate of return on the money they pay into the system. The system penalizes working women and those, such as African-Americans, with shorter life expectancies; it slows economic growth; and it prevents the accumulation of real, inheritable wealth. Most importantly, workers currently have no legal, property, or contractual right to benefits. All of these problems would be rectified under a system of individual accounts.

more years. Most proposals would not even start the change for several years. The only workers likely to be fully price-indexed are in their early 30s today.

Doing this alone would bring Social security into permanent sustainable solvency. Indeed, some studies have suggested that it may save more money than is necessary to achieve solvency. If that is the case, the impact might be softened for low-income workers, through a progressive application of the indexing.

However, while changing the indexing formula would restore Social Security solvency, it would do so by making Social security an even worse deal for younger workers, reducing their already dismal rate of return, and leaving many low-income seniors with inadequate benefits. It is in this context that individual accounts should be considered.

Because individual accounts would give workers the chance to take advantage of the higher returns available through capital investment and the power of compound interest, it would enable workers to offset at least some of the reductions they would otherwise incur.

To see how this would work, compare the difference between the expected return on capital investment and the implied return that a young worker can expect from Social Security. On average, workers retiring today can expect to receive a return of approximately two percent on their Social Security taxes, and future workers can expect even lower. However, the Social Security Administration estimates that a balanced portfolio of stocks and bonds could expect to earn returns of approximately 4.7 percent, net of administrative costs. To provide a vastly oversimplified example: a worker earning $30,000 per year will pay roughly $120,000 in Social Security taxes over a 40 year working lifetime. A two percent return on that money yields Social Security benefits equivalent to $185,000. But a 4.6 percent return would yield $344,000, nearly twice as much. Using only slightly more optimistic assumptions, such as using a 60/40 stock/bond mix, would provide even higher rates of return, though admittedly it would increase the variability of returns.

Thus a worker giving up a portion of his expected traditional Social Security benefits, but investing a portion of his Social Security taxes could reasonably expect a higher return, and accordingly higher retirement benefits.

Given the above, I believe that individual accounts must be part of any successful Social Security reform. There is no guarantee that future retirees will receive benefits equal to what they are currently promised. But those promises are illusory. However, individual accounts can ensure that future workers will receive higher benefits than Social Security could otherwise pay them. Moreover, those benefits would have the added advantage of belonging to the worker, and could be inherited if the worker died prematurely.

I do not pretend that individual accounts are a magic bullet. But they are clearly the best answer to Social Security's problems. They will create a better and more secure retirement system for American workers. I urge the Policy Committee to keep an open mind, as this debate unfolds.

Thank you.