Privatizing Social Security: Beyond the Theory

On February 6 and 7 the Cato Institute held a conference, "Privatizing Social Security: Beyond the Theory," to examine ways to translate the theory of Social Security privatization into a working system of individually owned, privately invested accounts. Speakers included Donald Marron, chairman of USB PaineWebber; Martin Feldstein of Harvard University; Milton Ezrati of Lord Abbett; Andrew Samwick of Dartmouth College; and William Shipman of State Street Global Advisors. Excerpts from their remarks follow.

Donald Marron: One of the exciting things about today compared with four or five years ago is that America has won several battles on Social Security. First, Social Security is no longer the third rail of politics. Second, it will be privatized, at least partially. So the real battle, the third and the most important, is getting it done.

If we don't do it soon, we will lose momentum. There are five or six keys to getting closer to privatization. One, any solution, by definition, has to be bipartisan. Two, we must involve all the affected groups. Many of them have very legitimate concerns. Everybody has to be included because this is such an emotional issue.

Three, we've got to go through the political process. Four, we must involve the investment community; the shareholders; and the owners of Social Security, the people. Finally, we must educate people. When we did surveys, both in the commission I chaired with Senators Gregg and Breaux and for USB PaineWebber, we found that a full 50 percent of Americans did not understand these issues of Social Security and financing a secure retirement.

It doesn't matter if you view Social Security as a tax or as a saving plan. Either way, you are in trouble. It is a regressive tax, and, like all other taxes, over time it would increase. It isn't a good savings plan because its return is less than 2 percent. When you start to look at it that way, you begin to realize the dilemma the new administration faces.

I disagree with anyone who says we should put off reform for 30 years because more money will be coming into the system. Do it now when we can afford to—even if we don't get it exactly right.

There are many variations on the plan we devised, but they all get to the same core issue: How do you provide a future for people who are going to live longer and want more flexibility in their lives?

Donald Marron: "Social Security is no longer the third rail of politics."

Andrew Samwick: One of the worst ideas advanced during the presidential campaign was the notion that the trust fund bankruptcy date is in any way relevant to the discussion of long-term reform. Nothing happens in 2037 that doesn't already happen in 2014, save a convenient relabeling. It may be the case that George W. Bush on his feet did not give a clear answer to the question, "What do you do about the transition costs?" But it is interesting that he was the one who was asked the hard question.

You could have asked the same question of candidate Al Gore in a slightly different way: "Once you allegedly shore up the trust fund until 2055, what do you do then?" Where was the popular press asking that question of the opposing candidate? The answer is that you sit on your hands while the tax rate has to go up to 6 percentage points.

Critics say we don't need reform because we can use about 2 percent of taxable payroll to restore solvency until 2075. Well, that's true and that's 2 percent of payroll and it doesn't seem like much, but in 2076 and 2077 and on through 2079 you liquidate the one year's worth of benefits left in the trust fund, and then you have to raise payroll taxes by more than 6 percentage points. The objective of people who favor personal retirement accounts should be to state the choice clearly: you either cut benefits for people who have no other place to get the money in 2075 or you raise taxes to the tune of 6 percentage points of payroll. That's the stark choice that people are running away from. I think that we need to tell the American people that, whether or not they like it, whether or not it is bitter medicine. That's the choice they'll be confronted with. And the Cato Institute (along with other similarly minded organizations) has to be the force that puts that choice in the forefront.

So if you take 2 percent of payroll and, instead of using it to prop up the existing system, use all the new money in a system of personal accounts instead of the pay-as-you-go system, what do you get? Well, if you earn a 5.5 percent rate of return, which is the number we've used as the after-corporate-tax return on investments in the corporate sector in the postwar period, by 2045 the personal retirement accounts can pay benefits equal to 4.75 percent of payroll. In 2045, using the actuaries' intermediate assumptions, you've got a financial gap of only 4.6 percent of payroll. Under a 2 percent plan that's the first year you're out of the woods. The solvency problem is then covered on a yearly basis, and your only question is how much of the debt that you issued during the course of this transition do you still have to pay off. That takes you another seven years or so.

By 2075, if you've been giving 2 percent of payroll to personal retirement accounts, you're now throwing off about 9 percent of payroll. The gap in 2075 is only 6.14 percent of taxable payroll. So you have more money than you would need to solve these problems. You should start giving tax relief if you haven't given it already.

Milton Ezrati: Apart from the red herring of transactions costs, risk is the primary focus of most objections to Social Security privatization. Especially in government circles, those in authority remain concerned that average Americans—Joe and Jane Six-pack—will fail to manage their investments so that they provide for retirement. Some observers have worried about how vulnerable Joe and Jane might be to unscrupulous financial types, who will channel their privatized retirement fund into dubious

“Under any reasonable set of assumptions, it will always be less expensive to move toward a market-based system than it will be to stay with a pay-as-you-go system.” —William Shipman

investments and charge high fees that eat up any returns. (The last time I looked, we in this country had the Argus-like Securities and Exchange Commission to guard against such abuse, but, evidently, some officials lack faith in the ability of other officials to protect the public.) Mostly, however, the objections to a privatized plan involve Joe's and Jane's ability to invest money so it will survive the inevitable vicissitudes of financial markets and grow enough to provide for retirement.

The first concern is that Jane or Joe will retire in a down year for the market and so have to cash out with insufficient assets. I cannot see why this misconception is so widespread. It not only flies in the face of sound investing; it flies in the face of common sense.

Why, I have to ask, would anyone, whether an investment guru or a socialist who hates "The Street," want to withdraw all investments on the day of retirement? You do not wake up on the first Monday after you retire and swap your stocks for an annuity. Most people, when they retire, plan to live for a few years, at least, and they want to keep their investment to provide for this future.

The damage this argument does to common sense is dwarfed by the violence it does to rudimentary investment sense. Indeed, it shows a complete ignorance of the most elementary of investment concepts. Because markets are so very volatile, timing them is a dangerous business; so you average in and average out, buying bit by bit over time and selling in the same way. That is called "dollar cost averaging." It is not rocket science. When you want to get out of the market, because of some lifestyle change like retirement, you plan it well ahead of time and move out gradually, over a period of years perhaps, so that you do not get stuck having to cash out in a down year.

We want our system to dissuade Joe and Jane from moving their respective portfolios into and out of asset classes quickly.

The second general risk that seems to concern folks about privatization is that Joe and Jane, in their impressionable ignorance, will chase investment fads, like the dot-com craze, getting into them too late (in other words, buying high) and getting out too late (selling low). Since that can happen to even the most seasoned professional, the investment principle is to always avoid putting all your money in a narrow range of securities or even a single asset class: stocks, bonds, real estate. You diversify your holdings across a number of securities and different asset classes.

We will have rules to ensure that Jane and Joe have portfolios diversified across a good number of holdings and across different asset classes.

The last general fear is that Joe and Jane will fail to build portfolios that are right for their individual circumstances, that they will miss needed growth when young or fail to build in the kind of holdings that provide income when they get older and need to live off the investment nest egg. There is no denying that different stages of life require different sorts of investments. Young folks should like aggressive, growth-oriented stocks, while retirees should like bonds and annuities.

Martin Feldstein: "An investment-based system can deliver higher benefits and reduce the tax burden."

We want our rules to help Jane and Joe configure their investments.

If our regulations simply direct people according to these simple and straightforward investment Principles—avoid market timing, diversify thoroughly, and make the portfolio reflect personal circumstances—they will guard effectively against most investment risks at least as well as any sophisticated corporate pension does.

Martin Feldstein: I am convinced that the time has come to move from advocacy to implementation. I believe that the nation is now ready for transition. Shifting to an investment-based account system is the right way to solve the most important fiscal problem facing the United States and indeed the other industrial countries of the world: to provide the retirement income of an aging population. A majority of the population supports the change. That became clear during the campaign. And, frankly, the people supported the switch even before they learned how much an investment-based system can deliver. I think that as they learn more their support will be even stronger.

An investment-based plan makes it possible to maintain benefits projected in current law without an increase in taxes. Indeed, in the long run an investment-based system can deliver higher benefits and reduce the tax burden below the current 12 percent. How can any responsible member of Congress reject such an opportunity? The actuaries of the Social Security Administration have clearly stated that the current pay-as-you-go system is not capable of maintaining projected benefits without a major increase in tax rates.

Let me emphasize that this is not a temporary problem that will go away as the baby boomers pass through the retirement cohort. It is a permanent problem caused by the aging of the population.

The Social Security actuaries tell us that a young person entering the labor force now who will have average earnings throughout his working life will get an implicit rate of return on his contributions of about 1 percent. In contrast, the rate of return on the Treasury's own inflation-protected bonds is now 3.5 percent. Let's assume a pay-as-you-go rate of return about twice what the Social Security actuaries predict, 2 percent instead of 1 percent. And for the investment-based system assume a real return of only 5.5 percent. Even with these very conservative assumptions, calculations show that the investment-based system can finance any stream of retirement benefits with contributions to personal retirement accounts equal to only one-third of the taxes that would have to be paid in a pay-as-you-go system. The implication is clear. It would take an 18 percent payroll tax to finance projected benefits in the pay-as-you-go system, but those same benefits can be financed with investment-based savings and personal

Continued on page 14

SOCIAL SECURITY *Continued from page 3*

Investment analyst William Shipman examines the transition to a privately funded system.

needs to design a low-cost system based on priorities and that time must be allowed for the implementation of the new system.

Other speakers at the conference included PaineWebber chairman Donald Marrons; Rep. Charles Stenholm (D-Tex.); Michael Barone of *U.S. News & World Report;* Thomas Saving of the Social Security Board of Trustees; Shane Chalke of AnnuityNet.Com; Milton Ezrati of Lord Abbett; and Cato's Michael Tanner, José Piñera, and William Shipman.

The conference, organized by Tanner, director of Cato's Project on Social Security Privatization, and Andrew A. Biggs, Social Security analyst at Cato, can be viewed with RealPlayer on Cato's main Web site, www.cato.org, or on Cato's Social Security Web site, www.socialsecurity.org. ■

Joel Rosenberg, Cato's Casey Lartigue, and Cato adviser Deroy Murdock talk at Social Security conference.

NORWAY *Continued from page 13*

its or demerits of any particular party, however, what's striking about the furor surrounding Norwegians' increasing openness to new (for them) political ideas is that establishment critics haven't merely taken their countrymen to task for their opinions. No, they've scolded them for daring to think they have a right to have opinions. Brought up on the mantra that "we are all social democrats" and the doctrine that the state knows best, how dare Norwegians start thinking for themselves?

Yet this is apparently just what some younger Norwegians have at long last begun to do. More fluent in English than their parents and having traveled more widely outside their own country, they feel less bound than previous generations to Norway's distinctive social and political traditions and more a part of the world beyond the fjords. They've seen firsthand the workings of societies and economies other than theirs, and they like much of what they have seen. Many have figured out that the opposite of individual rights isn't community spirit but government control, and they've had enough of that, thank you. If the recent poll results tell us anything, in short, it's that, in defiance of a lifetime of careful training, many young Norwegians have grown tired of marching in leftist lockstep and wish to claim their individual voices as citizens of a democracy. And that, in itself, isn't bad news at all. ■

FORUM *Continued from page 7*

retirement accounts funded with about 6 percent of the same earnings base—or by a mixed system with the current 12 percent payroll tax and 2 percent savings in personal retirement accounts.

William Shipman: The language surrounding the transition cost issue—that moving to a market-based system will force some people to pay twice, both for their own retirement benefits and for those of people who are currently retired—is rather seductive for a couple of reasons. One, it's true. But more important, it's not complete. The reason that it's not complete is that it does not explain what happens if we do not change the system.

The unfunded liability for the Old Age and Survivors Insurance portion of Social Security is roughly $9 trillion by one measurement. That's the cost of doing nothing. And that's the cost we must compare to the costs of transitioning to an alternative market-based system.

Under an alternative system of personal retirement accounts, individuals will accumulate enough wealth so that when they retire the government will not have to pay them anything. Now, individuals may or may not choose to take part. For a 21 year old this is a lay-up decision: That individual will take the deal of a market-based structure. For a 65 year old it may also be a lay-up decision, in that he would not take the market-based structure because he doesn't have enough time left to save and invest.

There must be an age someplace between 21 and 65 at which what people would receive from Social Security would equal what they would receive from a market-based structure. Let's just assume that age is 40. Then all rational individuals over the age of 40 will stay with Social Security, and all rational individuals younger than 40 will go into a market-based structure. We now have parameterized the nut that must be cracked.

We know the size and ages of the group that will remain in the current system, and we know that no one else can join. Once everyone in the group has died, the government's Social Security obligations will go to zero. Let's assume that we issue debt to pay benefits for just this group. The debt will increase during the transition period, but over time, as the group ages and dies, the benefits paid will begin to fall. Eventually, the debt is paid off through the remaining payroll taxes of the ever-expanding younger cohort. At that point there is no employer or employee tax. Individuals who save and invest will be able to support themselves in retirement. I would say that, under any reasonable set of assumptions, it will always be less expensive to move toward a market-based system than it will be to stay with a pay-as-you-go system. ■