National Center for Policy Analysis

BRIEF ANALYSIS
No. 302
For immediate release:
Monday, July 26, 1999

Five Principles of Social Security Reform

Politicians in both major parties now recognize that the existing Social Security system is unsustainable and must be reformed. The following are five principles that should govern our thinking about reform.

Principle No. 1: The Trust Funds Don't Matter. Our Social Security system is based on pay-as-you-go finance. Payroll tax revenues are not stashed away in bank vaults or invested in real assets. They are immediately spent — on Social Security benefits for current retirees and on other government programs.

The Social Security trust funds are not real trust funds in any meaningful sense of the term. They are merely an accounting mechanism designed to track the inflow and outflow of Social Security taxes and Social Security payments. Technically, the trust funds hold special government bonds, representing the amount by which payroll tax revenues have exceeded benefit payments. Indeed, one might think of the scheme as one in which the government borrows the Social Security surplus and gives Social Security bonds.

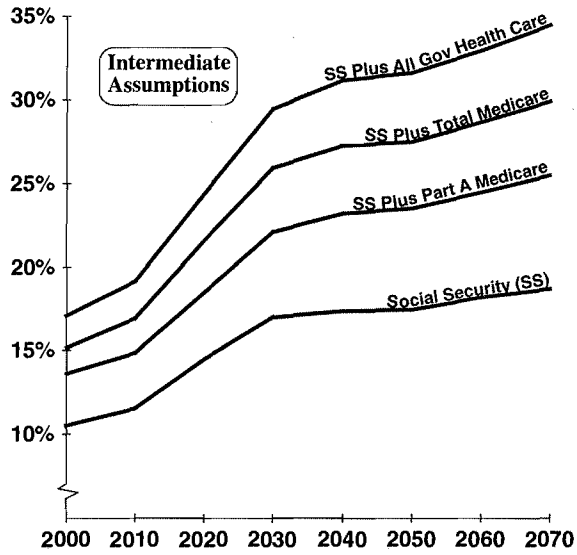
However, the special bonds held by the trust funds are nonnegotiable. They cannot be sold on Wall Street or to a foreign investor. They do not count as part of the official, outstanding debt of the U.S. government. They are nothing more than IOUs that one branch of government keeps writing to another.

On paper, the Social Security trust funds have enough IOUs on any given day to "pay" Social Security benefits for about 17 months. In reality, they cannot pay anything. Every asset of the trust funds is a liability of the Treasury, resulting in a balance of zero. So for the Treasury to write a check, it must first tax or borrow.

Principle No. 2: Future Tax Rates Do Matter. According to the most recent projections of Social Security trustees, the tax rate needed to pay benefits to retirees will grow continuously — as far into the future as we care to look. And these taxes will not be paid in a vacuum. The federal government's commitment to provide health care benefits for the elderly through Medicare, Medicaid and several other programs is also unsustainable.

FIGURE I

Elderly Entitlement Spending As a Percent of Taxable Payroll



Source: National Center for Policy Analysis and *1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Today the payroll tax that funds Social Security is 12.4 percent. By 2045, when today's 21-year-olds reach retirement age — which at that time will be 67 — the government will need 17.4 percent of workers' wages to pay projected benefits. Add in the amount needed to fund Medicare and other health care programs for the elderly and we will need a total tax rate of more than 31 percent. [See Figure I.] This is based on the trustees' intermediate assumptions.

Under the trustees' pessimistic assumptions, by 2045 the government will need 21.7 percent of workers' wages to pay projected Social Security benefits and more than twice that figure for elderly health care. The total tax rate needed will be more than 48 percent of workers' incomes. [See Figure II.]

Principle No. 3: A Solution Requires Investment in Income-Earning Assets. Over the past seven decades the real pretax rate of return on a balanced portfolio (60 percent stocks and 40 percent bonds) has been slightly more than 8.5 percent. After paying federal,

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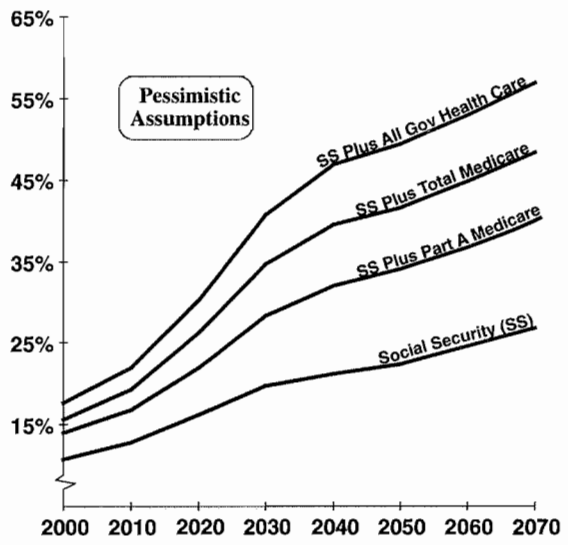
state and local taxes on financial investments, returns have averaged about 5.5 percent. By comparison, the Social Security system promises young workers a return on their payroll taxes of less than 1 percent. Moreover, private capital formation can replicate Social Security's promises at a fraction of the cost. In an analysis for the NCPA, Texas A&M University economist Andrew J. Rettenmaier found that with an annual contribution of 4.2 percent of wages, a personal retirement account invested in a balanced portfolio could replace Social Security benefits.

Principle No. 4: Transaction Costs Can Be Minimized. Critics of Social Security reform say the administrative costs of individually owned and privately managed Social Security accounts would be too high. (Administrative costs include such things as collecting contributions, record keeping and paying out benefits.) However, there are many examples of investment plans with low administrative costs:

- Total annual costs for large companies' defined contribution retirement plans are less than 2/10ths of 1 percent.
- Mutual funds that follow the S&P 500 have a median administrative cost of less than 4/10ths of 1 percent.
- The investment and administrative costs of the Thrift Savings Plan for federal workers are less than 1/10th of 1 percent.
- By contrast, according to the best research on this issue, by Olivia Mitchell of the University of Pennsylvania, the U.S. Social Security system costs a little over 3 percent of benefits to run.

FIGURE II

Elderly Entitlement Spending As a Percent of Taxable Payroll



Source: National Center for Policy Analysis and *1999 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*

Some critics worry that the low administrative costs of private plans cannot be duplicated for the millions of "mom and pop" firms across the country. But Bill Shipman of State Street Global Advisors has devised a platform to keep expenses for small business at less than 4/10ths of 1 percent. [See NCPA Brief Analysis No. 289, "Administering Private Social Security Accounts."]

Principle No. 5: Government Can Guarantee Benefits for Individual Retirees. Under the current Social Security system, retirement benefits are subject to *political* risk — the risk that when costs become too high, politicians will reduce future benefit payouts by raising the retirement age, changing benefit formulas or adjusting cost-of-living increases. These adverse outcomes occurred the last time the system was "reformed" in 1983 — along with increased payroll taxes on workers and employers.

Opponents of an investment-based system say that personal retirement accounts would exchange political risk for *market* risk — the risk that the stock market may decline precipitously, as it did in 1987 or even in the crash of 1929.

Yet government can afford to guarantee that no one will be worse off under the reformed system — and the cost of making good on that guarantee is a small fraction of the cost of running the current pay-as-you-go system. In fact, two reform proposals — by Sen. Phil Gramm (R-Texas) and by Reps. Bill Archer (R-Texas) and Clay Shaw (R-Fla.) — explicitly guarantee that all retirees will receive a pension at least as great as the one promised under the current system.

This Brief Analysis was prepared by NCPA President John C. Goodman and Policy Analyst Joe Barnett.