Through the Looking Glass

A CAGW Special Report

A Social Security Issue Brief

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Introduction

The federal government and the political class are in a quandary. As a result of Social Security trust fund mismanagement, a misguided but stubborn belief in Ponzi schemes, and the seismic shifts in the nation's demographic landscape, the Social Security system is on a collision course with bankruptcy and everybody has a scheme to rescue it. How will Washington ensure the solvency of the nation's best-known retirement program?

Social Security was set up in 1935 as an income safety net of last resort for elderly Americans, as President Franklin Delano Roosevelt envisioned. In his "Message to Congress Recommending Improvements in the Social Security System," delivered on January 16, 1939, he said, "We shall make the most orderly progress if we look upon social security as a development toward a goal rather than a finished product. We shall make the most lasting progress if we recognize that social security can furnish only a base upon which each one of our citizens may build his individual security through his own individual efforts."

The trust fund has been running a surplus since 1937. At that time, the system flourished, with 42 workers paying into the fund for each retiree. In 1998, however, only three workers financed each retiree. As baby boomers age and retire, the dwindling ratio of workers to retirees means that the system will begin to hemorrhage money starting in 2014. The most recent Social Security Trustee's Report lamely sought to reassure nervous baby boomers that Social Security won't really go bust until 2034, two years later than predicted just last year.

Unfortunately, many individuals view that extension of the system's collapse as an excuse to do nothing. Numerous plans to salvage Social Security are being bandied about, ranging from complete privatization to raising payroll taxes to fortify the current pay-as-you-go system. The debate is shaping up to be more a clash of political cultures than an effort to develop a straight forward formula for bailing out the troubled entitlement program. Indeed, the outcome of this national conversation could either herald a new era of personal responsibility and choice or solidify an ethos for government intervention and control.

Background

This Citizens Against Government Waste (CAGW) issue brief will broadly outline and grade each of the three options available to Congress and the Clinton Administration to restore the fiscal and social integrity of Social Security.

Before addressing the potential solutions it is important to understand how the country got to this point. Beginning in fiscal year (FY) 1969, Social Security and other government trust funds began to be counted in the unified budget, as advised by an expert panel commissioned by President Lyndon Johnson in 1967. As mentioned before, the trust fund has been running a surplus since 1937, which has come in handy for Congress. Legislators, who rapidly acquired a taste for spending beyond the taxpayers' means, used Social Security trust funds to mask budget deficits. The 1974 Congressional Budget and Impoundment Act required Congress to submit budget resolutions, which did away with the practice of passing each agency's budget separately. All subsequent budget resolutions were also to reflect a unified budget including Social Security.

During the 1980s, some members of Congress made attempts to sequester and insulate Social Security trust funds from the general budget, but Social Security wasn't taken completely "off budget" until 1990. The driving force behind the push to move Social Security off budget was the continued use of trust fund monies for other government spending programs. However, Congress has largely ignored Social Security's off budget status. The easy accessibility of the trust funds has encouraged Congress and the executive branch to spend money the taxpayers don't have.

Congress spends trust fund monies and writes IOUs, which are expected to total $848 billion by the end of FY 1999. These IOUs will start to become due in 2014, when Social Security outlays will begin to exceed revenues. Although some dismiss the IOUs as an accounting gimmick, these IOUs represent real money. Once the Social Security trust fund begins to run a deficit, those IOUs will have to be cashed in to pay benefits. In short, declaring Social Security "off budget" has done little to protect surplus revenues or guarantee future benefits for retirees. The FY 2000 budget resolution approved by Congress reinforces Social Security's off-budget status. In addition, the House and Senate are considering legislation to try to reinforce Social Security's off budget status with regard to emergency and all other spending bills.

This issue brief uses two measuring sticks to determine the merits of each proposed plan: (a) the degree to which the plan would ensure fiscal solvency of the system and (b) the degree of personal liberty inherent in the plan.

Plan A: Maintain Status Quo and Increase Payroll Taxes

The least talked about, and presumably least viable, option is to tread water and use higher payroll taxes as a life preserver. This plan would sustain the current system's basic structure and simply skim more from taxpayers' paychecks to finance future shortfalls.

A. Fiscal Solvency:
Shoring up the current system by increasing taxes would be no more effective than applying a Band-Aid to a major hemorrhage. Studies indicate that payroll taxes would have to be increased by 54 percent (from 12.4 percent to 19 percent) in order to stave off fiscal insolvency for 75 years. After that, no one knows what the tax rate would have to be. This option would also do nothing to stifle elected officials' propensity for raiding the trust fund to fund pork-barrel spending on egregiously wasteful programs.

B. Personal Liberty:
The current funding mechanism resembles a shell game and does little to help retired workers live comfortably. The average payment is $780 per month, a stipend that often necessitates financial sacrifices by seniors. Social Security was contemplated as an income program of last resort for aging Americans, not as their primary and only source of support. Many analysts also point to another overlooked factor: lost opportunity costs. Had the baby boomer's parents' generation been able to invest their "contributions" in the stock market, even during its sluggish periods and out-and-out crashes, those retirees would today be enjoying much higher incomes than those provided by Social Security. The average annual return on investment on the stock market over the last 70 years has been approximately 9 percent, compared to Social Security's average return of 1 percent.

Overall Grade: "F"

Plan B: Half a Loaf

The second option — allowing the federal government to invest Social Security payroll taxes in the stock market — is the brainchild of the Clinton Administration. The President proposes to earmark 62 percent of the budget surplus for Social Security over the next 15 years and to have federal money managers invest these sums in stocks, bonds, and mutual funds.

However, this plan relies upon a fiscal illusion. The much-ballyhooed "surplus" is actually money that was set aside to pay Social Security benefits in the first place. In essence, President Clinton is counting, and proposing to spend, the surplus twice.

At a glance, a plan to invest payroll taxes in the market is attractive. After all, millions of average Americans have for years used the stock market to orchestrate successful capital formation strategies for their retirements. But read the fine print: The federal government would buy stocks and bonds with the surplus, and hold them in the Social Security trust funds. The bonds would subsequently be sold on the open market whenever the government needed to pay benefits. Specifically, the general revenue fund, rather than payroll taxes, would provide the income stream for this new system. Such a shift would be dangerous. Though the payroll tax system is structurally untenable, this plan would eliminate its only advantage — the payroll system keeps the system accountable, discreet, and somewhat tidy. Under "Plan B," there would be no limitation on Social Security spending if general revenues could be used at any time to buy bonds. This would in effect remove the one check built into the Social Security system, thereby allowing the system to expand or contract depending on the political mood.

Other changes would be forthcoming. Social Security officials would morph from actuaries who oversee the collection and redistribution of revenues into investment bankers. The federal government would immediately become the 800-pound gorilla on Wall Street, with the power to dictate failures and successes. It is naive to assume that politicians would not be tempted to manipulate these investments. It isn't hard to imagine a future-president Al Gore prohibiting Social Security monies from being invested in sectors or industries he deemed to be anti-environment. Or a future-president George W. Bush demanding an end to investing in corporations that engage in trade with perceived enemies abroad. In short, politically driven investment decisions could send financial shock waves across the U.S. economy as a whole as well as the individual personal retirement plans of millions of Americans.

Federal Reserve Board Chairman Alan Greenspan, on several occasions, has publicly denigrated this proposal, predicting that such a massive government intervention in the stock market would only supplant existing stock investors while doing nothing to raise national income or savings. Greenspan has also said that he is unable to come up with a logical reason to implement such a plan. Dyed-in-the-wool advocates of big government have embraced the idea, presumably because it allows for continued government control of the Social Security system, as well as increased government control of the economy.

A. Fiscal Solvency:

Under this plan, the life of Social Security is undeniably extended. However, not only does "Plan B" disregard Social Security's structural flaws, there is no way to know how long this "fix" would last. Americans should never lose sight of the fact that any money used to underwrite such a venture would be obtained the old-fashioned way — through continued confiscation of payroll taxes. In fact, the political squabbling over how to dispose of the "surplus" obscures the fact that the nation's federal debt is still rising and expected to increase by $252 billion by 2004 — a far cry from being "awash" in extra cash.

B. Personal Liberty:

Government control of investments in the stock market could quickly fall prey to the machinations of politicians and would make a mockery out of the concept of a free market. A significant portion of

individuals' retirement funds would become dependent on the market savvy of government-sponsored investors.

Overall Grade: "D"

Plan C: Financial Liberty Through Choice

The third proposal involves the partial privatization of Social Security. Many big government proponents regard taxpayer control and ownership of their retirement accounts as anathema, and they have launched a campaign to turn the idea into the boogie man of American politics. They resort to the usual images of avaricious corporate America profiting at the expense of unsuspecting taxpayers. However, partial privatization offers beneficiaries choice and opportunity for growth, and it has the added attraction of having worked in other countries.

The most popular version resembles the 18-year-old Chilean model. There, 10 percent of a worker's wages is automatically deposited into an individual retirement account each pay period. Essentially, Chilean workers control the disposition of their funds and the government is responsible for overseeing the investment management companies. In Chile, there are currently 12 management companies from which workers can choose. These fund management companies are certified and regulated by the Chilean government to ensure their solvency and adherence to sound business practices. Each company must guarantee a minimum return on investments. If the minimum is not met, the difference is paid from the company's reserve fund. Should the reserve fund be depleted, the government would step in to make up the shortfall. The incentive for the companies is to maintain a higher-than-required return on investment in order to attract new clients.

The introduction of a similar plan in the United States would not be compulsory. No one would be required to sign up for the individual retirement accounts, and the system would be phased in, presumably attracting increased participation as beneficiaries begin to recognize its financial benefits. Beneficiaries who wish to stay in the current system could do so. It is generally assumed that older workers would not flock to enroll in personalized retirement accounts, mostly because they might believe there wouldn't be the time to accumulate significant portfolio value. However, a large proportion of younger and middle-aged workers, a significant percentage of whom have told pollsters that they have little confidence in Social Security's long-term survival, could be expected to make the transition.

A. Fiscal Solvency:

The partial privatization and personalization of Social Security is the key to its future solvency. Instead of relying on continued confiscation of current workers' wages to pay benefits for older generations, private investments would usher in a cohort system, in which an individual's lifetime investments would come back, with dividends, to that same individual at the time of retirement. This would also effectively prevent the government from tapping these funds to finance other government spending. In order to ensure savings, the accounts could be rendered off limits to the account holder until he or she is age 65 or older, as is specified by many IRA plans.

B. Personal Liberty:

Financial liberty leads to greater personal liberty. This plan has many positive elements, but one of the least talked about is that these individual retirement accounts would be owned by the individual, unlike the Social Security trust fund monies.

Overall Grade: "A"

Conclusion

The looming crisis in the Social Security system has shaken the confidence of all Americans, particularly seniors. But Social Security's troubles are not insurmountable if officials in Washington resist their natural impulse to make a slap-dash effort at reform. They must act with alacrity to address the system's structural problems, with as little partisan squabbling as possible.

However, the recent example of the Bipartisan Commission on the Future of Medicare, an even more complicated and distressed entitlement program, doesn't bode well. After a year of research and negotiation, the Commission was ultimately paralyzed by partisanship and failed to produce any recommendations. Apparently, for President Clinton and his allies think it is more valuable to use Medicare as a political bludgeon during the upcoming election cycle than to fix it. Social Security reform will surely face similar partisan pressures and could suffer a similar fate unless cooler heads prevail.

In order to secure a stable financial future for all Americans, Social Security must be reconfigured for the next century in a way that guarantees financial and personal freedom. The concepts of choice, ownership, and free markets are the appropriate answers for the world's leading democracy and have succeeded in other countries. It's time for members of Congress and the President of the United States to put political differences aside and fix Social Security by providing Americans with the secure retirement incomes by opting for financial stability and personal liberty in the form of personal retirement accounts.