SOCIAL SECURITY OPTIONALITY: REDUCING THE WEALTH GAP

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by

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Executive Summary

The latest Annual Report of the Social Security Board of Trustees warns that Social Security will run short of funds to pay promised benefits by 2033, and quite possibly as soon as 2028, just 13 years from now. Indeed, the disability insurance portion of Social Security will not have sufficient funds to pay promised benefits *next year*.

Once the trust funds run out, under intermediate assumptions, the current total Social Security payroll tax rate of 12.4 percent will have to jump in 2033 by close to 40 percent to start, to about 17 percent. Under so-called pessimistic assumptions, paying all promised benefits in 2030 would require raising the total Social Security payroll tax rate to close to 20 percent, an increase of almost 60 percent. Paying all benefits financed by the payroll tax would require that tax to soar to close to 40 percent, more than double.

All workers across the board, of all income levels and family combinations, would now get much higher benefits saving and investing in the market through personal accounts than the benefits Social Security even promises today, which the program cannot pay. A two earner middle income couple saving and investing over their lifetime in their own personal savings and investment account what would otherwise be paid into Social Security would reach retirement at just standard long term market investment returns with $1,223,602 in today's dollars, after adjusting for inflation.

That fund would be able to pay out of the continuing investment returns alone just about *twice* what Social Security promises to pay them under current law, *while still allowing them to leave the $1.2 million fund to their children*. Or they could use the fund to buy themselves an annuity that would pay them over four times what Social Security currently promises, let alone what it can pay.

A Proposal for Social Security Reform.

All workers under 40 would be allowed the freedom to choose such personal accounts for their Social Security retirement benefits. For those that make this choice, taxes will be rebated into their accounts equal to 10% of the first $10,000 they earn each year, and 5% of everything above that, up to the Social Security maximum taxable income. That would be roughly equal to the employee share of the payroll tax. But the rebates would be financed by general revenues, leaving all Social Security payroll tax revenues to continue to flow into Social Security unchanged.

The Treasury Dept. would contract with private fund managers to offer investment funds to workers who exercised the personal account option, invested entirely into index funds for the S&P 500. For those that choose personal accounts, workers of all income levels and family combinations would receive higher total future retirement benefits, rather than lower benefits. Workers would receive the benefits that can be financed by their personal accounts. Plus they would also receive a portion of promised Social Security retirement benefits equal to the portion of lifetime Social Security payroll taxes (OASI) that they had already paid while working, before they made the choice for personal accounts.

Those that choose personal accounts would be backed by a federal guarantee that those funds combined would equal at least what Social Security promises them under current law, or they will be paid a guarantee benefit every month equal to the difference. This would maintain the current Social Security safety net in full.

Social Security survivors and disability benefits would continue to be paid as promised under current law without change. There would be no change in Social Security of any sort for those already retired, or workers 40 and over not eligible for the personal account option. For those that do not choose to make the choice for personal accounts, they would continue to receive Social Security benefits as provided under current law without change as well, with no benefit cuts or tax increases of any sort.

Workers with personal accounts would be free to choose to leave any portion of their funds to their families or children. Those funds and any benefits payable from the personal accounts would be free of any tax.

Workers with personal accounts would be free to choose their own retirement age for benefits from the account, with market incentives to delay it as long as possible, because the longer they wait, the more funds would accumulate in the account, and the higher the benefits it can pay.

Such reform would eliminate all future deficits of Social Security, without any benefit cuts or tax increases, as validated by the Chief Actuary of Social Security. Indeed, ultimately the resulting savings in federal spending from the reform would amount to the biggest reduction in government spending in world history.

The proposed personal accounts for Social Security would do more to address the issue of wealth inequality than everything dreamed up by Elizabeth Warren and Hillary Clinton put together. After the first 15 years under the reform, working people across America would have accumulated $7.8 trillion in today’s dollars in their personal accounts. After the first 25 years, workers would have accumulated $16 trillion in today’s dollars.

The personal accounts funnel mighty, new rivers of savings and investment into the economy. Higher savings and capital investment mean higher productivity and increased wages for working people. That creates new jobs and new opportunities. The bottom line is increased economic growth.

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The Social Security Financial Crisis

For Social Security, the future the government's actuaries have long warned about is here. The latest Annual Report of the Social Security Board of Trustees warns that Social Security will run short of funds to pay promised benefits by 2034, and quite possibly as soon as 2028.[1] That is no longer sometime in the next century. That is as soon as13 years from now. Which means it will affect people already retired today.

Indeed, U.S. government reports project that the disability insurance portion of the program will not have sufficient funds to pay promised benefits *next year*.[2]

The root of the financial problem is that Social Security does not have a cushion of real savings and investment that can weather bad times. Social Security does not save the funds workers and their employers are paying in today to finance their future benefits. Social Security uses the tax payments coming in today to immediately finance the benefits for today's retirees. Social Security expects the future tax payments of future workers to finance the future benefits for today's workers.

Even when the system was running annual surpluses, close to 90 percent of the money coming in was paid out within the year to pay current benefits. The remaining annual surpluses each year were not saved and invested either. They were lent to the federal government and spent on other government programs, from foreign aid to bridges to nowhere, with the Social Security trust funds receiving only internal federal IOUs promising to pay the money back when it is needed to pay benefits. These internal federal IOUs are all that is held by the so-called Social Security trust funds, now totaling roughly $2.7 trillion.

As a result, Social Security is not a savings and investment system. It is a tax and redistribution system, where the money is taken from one group of people through taxes and just immediately redistributed to other people in benefits and other government spending.

When Social Security runs a deficit, as it is doing today and will do indefinitely into the future until the trust funds are exhausted, Social Security turns some of those trust fund IOUs over to the U.S. Treasury to get money back to continue paying promised benefits. But there is

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[1] 2015 Annual Report of the Board of Trustees of the Old Age and Survivors Insurance and Disability Insurance Trust Funds, July 22, 2015, Table IV.B4, p. 66.
[2] Id., p. 2, Table IV.B4, p. 66

no cash or other savings and investment held in reserve to pay back those IOUs. So where does the U.S. Treasury plan to get the money to pay them back?

From you. Since those IOUs are national debt, not assets of the federal government, they are owed by you, and you will have to pay them back for retirees to continue to receive all their promised Social Security benefits. Paying back the IOUs will be in addition to the hundreds of billions of dollars you and other taxpayers must pay in payroll taxes each year. When Social Security comes to the Treasury turning in trust fund IOUs to get the cash to pay promised benefits, the Treasury will get that cash either by raising your taxes or by borrowing still more and running even bigger deficits. This is why the long-term Social Security financing crisis has already begun.

That financing crisis accelerates in earnest once the trust funds run out. Payroll tax rates will then have to increase sharply to continue paying all the benefits promised by Social Security. Under so-called intermediate assumptions, the current total Social Security payroll tax rate of 12.4 percent will have to jump in 2035 by close to 40 percent to start, to about 17 percent.[3]

Under so-called pessimistic assumptions, which may be the most realistic,[4] paying all promised benefits in 2030 would require raising the total Social Security payroll tax rate immediately to close to 19 percent, an increase of about 55 percent.[5] Paying all benefits financed by the payroll tax would ultimately require the total payroll tax rate to soar to 35 percent, more than double, under so-called pessimistic assumptions.[6]

Payroll tax rate increases in these ranges will cause soaring unemployment, which in turn will mean less revenue than expected, which will require still higher tax rates. This gives a bracing new reality to the term "death spiral." The threat of this "death spiral," and the economic burden of such soaring payroll tax rates, does threaten future benefit cuts, which the U.S. Supreme Court has already specifically ruled are not constitutionally guaranteed, or even contractually guaranteed.

Why Personal Accounts Would Provide Better Benefits For Seniors Than Social Security

Even if Social Security could somehow pay all of its promised benefits, those benefits are inadequate, and represent a low, below market return on the Social Security payroll taxes working people and their employers pay throughout their lives. For most working people, even

[3] 2015 Trustees Report, Table VI.G2, p. 203.
[4] New studies from researchers at Harvard and Dartmouth show that Social Security's actuaries routinely underestimate the program's financial problems. Konstantin Kashin, Gary King, Samir Soneji, Systematic Bias and Nontransparency in U.S. Social Security Administration Finances, *Journal of Economic Perspectives*, Vol. 29, Number 2, Spring, 2015, pp. 239-258; Konstantin Kashin, Gary King, Samir Soneji, Explaining Systematic Bias and Nontransparency in U.S. Social Security Administration Finances, *Political Analysis*, American Economics Association, May 7, 2015.
[5] Id.,Table IV.G2, p. 204.
[6] Id.

if Social Security could pay all of its promised benefits, those benefits would represent a real rate of return of less than 1% on the Social Security taxes paid throughout their working years.[7]

For many workers, that real return would be negative, meaning less than 0%.[8] That is like depositing money in the bank, but instead of the bank paying you interest, you pay the bank interest for holding the deposit of your money.

Worst of all, **this is where Social Security is heading for all workers in the future.** For if the government raises taxes or cuts benefits, or does both, to eliminate the long-term deficits of Social Security, then the effective rate of return under Social Security will decline further for all workers across the board. Eventually, virtually all workers under Social Security would be driven down into the range of negative effective real returns.

Why doesn't Social Security pay better benefits? Because Social Security operates as a pure tax and redistribution system, with no real savings and investment anywhere, as discussed above. The tax money paid into the system by today's workers and their employers is not saved and invested for their future retirement. It is immediately paid out to finance benefits to today's retirees.

That means working people lose the compounding real returns they would gain from a lifetime of real savings and investment. Compare the pitiful redistribution Social Security returns above with real, standard, long term investment returns in the financial markets. Jeremy Siegel, in his definitive book *Stocks for the Long Run,* documents that the real annual compound rate of return on corporate stocks in the United States over the 200 year period 1802 to 2001 was 6.9 percent, after inflation.[9] It was the same 6.9 percent over the period 1926 to 2001, which included the Great Depression, World War II, the Korean War, the Vietnam War, and the Great Inflation of the 1970s.[10]

From 1926 to 2013, the real rate of return on Large Cap stocks, representing the larger companies in America, was 8.9 percent. The real rate of return on Small Cap stocks, representing smaller, mid-size firms, was 13.5 percent. A sophisticated, diversified portfolio of 90 percent Large Cap and 10 percent Small Cap stocks earned a 9.36 percent real return over that period. *This period covers the 2008 financial crisis.*[11]

Moreover, over the 50 year period from 1946 to 1996, corporate bonds averaged a real return of 4 percent.[12] Harvard Professor Martin Feldstein, former Chairman of the National

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[7] Peter J. Ferrara and Michael Tanner, *A New Deal for Social Security*, (Washington, DC: Cato Institute, 1998), Chapter 4.
[8] Id.
[9] Jeremy Siegel, *Stocks for the Long Run* (New York: McGraw-Hill, 2002), 3rd ed.
[10] Id.; *Stocks, Bonds, Bills, and Inflation 2014 Yearbook* (Chicago: Ibbotson Associates); Jeremy Siegel, *Stocks for the Long Run* (Chicago: Irwin Professional Publishing, 2014).
[11] *Stocks, Bonds, Bills, and Inflation 2014 Yearbook*
[12] Edgar K. Browning, "The Anatomy of Social Security and Medicare," *The Independent Review,* Vol. XIII, no. 1, Summer 2008, p. 12. See also, Siegel (the average real return on corporate bonds over the 200 year period from 1802 to 2001 was 5 percent); José Piñera, "Toward a World of Worker Capitalists," Transform the Americas, www.transformamericas.com, April 2000.

Bureau of Economic Research, and his associate Andrew Samwick calculated in 1997 a portfolio of 60 percent stocks and 40 percent bonds would have generated a real return of 5.5 percent over that same 50 years, and the same return over the period going back to 1926.[13]

Compounding the much higher, long-term, standard market investment returns over a lifetime adds up to an enormous difference as compared to the much lower returns offered by Social Security's pay-as-you-go, tax and redistribution system. A two earner middle income couple saving and investing over their lifetime in their own personal savings and investment account what would otherwise be paid into Social Security would reach retirement at just standard long term market investment returns with $1,223,602 in today's dollars, after adjusting for inflation. That fund would be able to pay out of the continuing investment returns alone just about *twice* what Social Security promises to pay them under current law, *while still allowing them to leave the $1.2 million fund to their children*. Or they could use the fund to buy themselves an annuity that would pay them over four times what Social Security currently promises, let alone what it can pay.[14]

All workers across the board, of all income levels and family combinations, would now get much higher benefits saving and investing in the market through personal accounts than the benefits Social Security even promises today, which the program cannot pay. Two low-income spouses somehow earning little more than the minimum wage over their entire careers would reach retirement with well over half a million in their personal accounts in today's dollars. That fund would be sufficient to pay them more than three times what Social Security promises them but cannot pay.

Across America, hundreds of billions, and ultimately trillions, in new savings and investment each year would flow through the personal accounts, increasing economic growth. The personal accounts over time would transform the payroll tax, the highest tax most working people pay, into a personal family wealth engine. This effective tax relief would further spur the economy. The result would be new jobs and higher wages and family income for working people today.

Proven Reforms That Have Already Been Shown to Work in the Real World

Such reforms have already been tried and proven to work spectacularly in the real world. That started with the South American nation of Chile, which enacted such a system of personal accounts for their Social Security system in 1981, which virtually all workers chose in preference to the public system. After more than 30 years of experience with those personal accounts, workers are enjoying multiples of the benefits that were promised but could not be paid under the old system, for about half the required payments, with dramatic gains for the economy as also described above.

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[13] Martin Feldstein and Andrew Samwick, "The Economics of Prefunding Social Security and Medicare Benefits," National Bureau of Economic Research Working Paper no. 6055, National Bureau of Economic Research, Cambridge, MA, June, 1997.
[14] Ferrara and Tanner, *A New Deal for Social Security*, Chapter 4.

Similar reforms have been adopted in other countries in Latin America, and elsewhere around the world. That includes the local government workers in 3 counties in Galveston, Texas right here in the USA, who adopted a similar system when that was allowed for state and local government workers prior to 1983, with similar results as in Chile. Another successful model for such personal accounts has been the Federal employee Thrift Savings Plan adopted 30 years ago.

A Proposal for Social Security Reform

The analysis above should make clear that the only real solution for Social Security is to transform its fundamental means of financing from pay-as-you-go tax and redistribution to fully funded savings and investment in personal accounts for each worker, as most voters thought Social Security originally was. That is what would be achieved through a proposal to empower working people with the freedom to choose personal savings and investment accounts that they each individually own to finance their future Social Security retirement benefits.

Under this plan, all workers under 40 would be allowed the freedom to choose such personal accounts for their Social Security retirement benefits. For those that make this choice, taxes will be rebated into their accounts equal to 10% of the first $10,000 they earn each year, and 5% of everything above that, up to the Social Security maximum taxable income. That would be roughly equal to the employee share of the payroll tax. But the rebates would be financed by general revenues, leaving all Social Security payroll tax revenues to continue to flow into Social Security unchanged. That means that this proposal would only cause the Social Security trust funds to grow to very high levels in the future, the highest in history.

The Treasury Dept. would contract with private fund managers to offer investment funds to workers who exercised the personal account option, as in the Federal Employee Thrift Savings program. These investment funds would be invested entirely into index funds for the S&P 500, a simple, low cost option that would earn high, long term, market investment returns.

For those that choose personal accounts, workers of all income levels and family combinations would receive higher total future retirement benefits, rather than lower benefits. Workers would receive the benefits that can be financed by their personal accounts. Plus they would also receive a portion of promised Social Security retirement benefits equal to the portion of lifetime Social Security payroll taxes (OASI) that they had already paid while working, before they made the choice for personal accounts.

Those that choose personal accounts would be backed by a federal guarantee that those funds combined would equal at least what Social Security promises them under current law, or they will be paid a guarantee benefit every month equal to the difference. This would maintain the current Social Security safety net in full in the personal account framework. Social Security survivors and disability benefits would continue to be paid as promised under current law without change. There would be no change in Social Security of any sort for those already retired, or workers 40 and over not eligible for the personal account option.

For those that do not choose to make the choice for personal accounts, they would continue to receive Social Security benefits as provided under current law without change as well. There would be no benefit cuts or tax increases of any sort for these workers, or anyone else, whether already retired or still working.

Workers with personal accounts would be free to choose to leave any portion of their personal account funds to their families or children, or to any other heir they designate. Those funds and any other benefits payable from the personal accounts would be paid free of any tax. Workers with personal accounts would be free to choose their own retirement age for benefits from the account, with market incentives to delay it as long as possible, because the longer they wait, the more funds would accumulate in the account, and the higher the benefits it can pay.

This proposal would be very similar to the personal accounts legislation proposed by Congressman Paul Ryan (R-WI) and Senator John Sununu (R-NH) in 2004 and 2005. That proposal was scored by the Chief Actuary of Social Security, who concluded that it would eliminate all future deficits of Social Security, without any benefit cuts or tax increases. That is because the reform would shift so much responsibility over time for the financing of retirement benefits to the private financial markets, and off the federal budget altogether. This reform would achieve the same results. Indeed, ultimately the resulting savings in federal spending from the reform would amount to the biggest reduction in government spending in world history.

The Chief Actuary of Social Security also concluded that the personal accounts proposed in the Ryan-Sununu legislation would be so obviously a better deal for workers and their families than Social Security, that he estimated that 100% of workers would choose the personal accounts. That score is still available at the Social Security Administration website at www.ssa.gov. The same would be true for the personal accounts proposed here.

The reform would also sharply reduce the unfunded liabilities of Social Security, currently estimated at about $25 trillion, which is effectively implicit national debt. That is almost 50% larger than the current official national debt. The proposed Social Security personal account reform would sharply reduce that unfunded liability, as the fully funded personal accounts over time take over more and more responsibility for Social Security retirement benefits. With 100% of workers choosing to exercise the personal accounts, the reform would produce the greatest reduction in effective national debt in world history.

Economic Effects: Addressing Inequality and Economic Growth

The proposed personal accounts for Social Security would do more to address the issue of inequality of wealth than everything dreamed up by Elizabeth Warren and Hillary Clinton put together. With such personal accounts, working people at all income levels would hold a substantial ownership stake in America's business and industries. The Chief Actuary's score for the Ryan-Sununu legislation concluded that after the first 15 years with those personal accounts, workers would have accumulated $7.8 trillion in today's dollars, after adjusting for inflation. After the first 25 years, workers would have accumulated $16 trillion, again in today's dollars. The same results would be achieved by the personal accounts for Social Security proposed here. A study by Harvard University Prof. Martin Feldstein indicated that if Social Security were shifted to a fully funded system like personal accounts, the concentration of wealth in the United States would be reduced by half.[98]

The personal accounts funnel mighty, new rivers of savings and investment into the economy. Higher savings and capital investment mean higher productivity and increased wages for working people. That creates new jobs and new opportunities. The bottom line is increased economic growth. Such increased capital would finance the practical implementation of our rapidly advancing science, leapfrogging our economy further generations ahead. These would all benefit working people today, soon after the reforms were adopted.

The personal accounts also effectively involve a major tax cut, effectively displacing the employee share of the payroll tax for workers under 40. That would further promote economic growth.

Financing the Transition

Any plan for personal accounts for Social Security involves a transition financing issue. As discussed above, Social Security currently operates on a pay-as-you-go basis; virtually all the money that comes in today goes out immediately to pay current benefits. If part of the money coming in goes for savings and investment in personal accounts instead, additional funds will have to come from somewhere else to continue paying all benefits promised to today's retirees. The need for this transition financing phases out over time as workers who are relying on their personal accounts instead of payroll taxes retire.

This is a cash-flow financing issue, however, not a matter of transition "costs." What the transition is financing is the increased savings and investment involved in shifting from a pay-as-you-go system with no real savings and investment, to a fully funded savings- and investment-based system. The Chief Actuary of Social Security wisely called it the "transition investment issue."

When you save $1,000 in a bank, you don't think that cost you $1,000. It doesn't *cost* you anything, because you still have the money, in your savings account. Of course, because you can't have your cake and eat it too, you can't spend the $1,000 you are saving, or else you wouldn't be saving it. That may create a cash-flow problem for you, depending on your personal finances. But it is not a matter of the savings *costing* you $1,000.

The transition financing for a system of personal retirement accounts is thus a matter of effectively financing the savings going into the personal accounts of working people across the United States, ultimately amounting to trillions and trillions of dollars. That accumulated savings and investment is not a cost to the economy; it is a mighty, productive contributor to the economy. Working people seeing money growing in their own personal accounts would certainly recognize it is not a cost but in fact an asset. The personal accounts are just a politically sophisticated means of shifting from current, completely non-invested, Social Security to a fully

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[98] Martin Feldstein, "Social Security and the Distribution of Wealth," *Journal of the American Statistical Association* (December 1976), pp. 90-93.

funded system based entirely on private savings and investment. That shift should be readily recognized as the complete, responsible, desirable solution to the problems of Social Security.

One simple means for financing this transition is just to borrow the funds. This would not constitute a net drain on private savings and investment, because of all the increased savings and investment going into the personal accounts. At most, this would involve a net wash, just borrowing back the increased savings and investment going into the accounts.

This was really Milton Friedman's vision for Social Security reform. He proposed just recognizing the unfunded liability of Social Security as effectively already federal debt. He consequently favored just formally recognizing the debt by issuing federal bonds to cover it. Working people could then just proceed to save and invest funds in their own personal accounts to finance their own future retirements.[15] That would still involve replacing over time Social Security's tax and redistribution, pay-as-you-go system with a fully funded, savings and investment system, with no unfunded liability.

But there is another way. My latest book, *Power to the People: The New Road to Freedom and Prosperity for the Poor, Seniors, and Those Most In Need of the World's Best Health Care* (Heartland Institute, 2015), discussed how to reform all the major entitlement programs – Medicare, Medicaid, Obamacare, and welfare, besides Social Security. Just as seniors are better off with personal accounts, receiving higher benefits rather than lower benefits, the other reforms leave the dependents on these entitlement programs better off than today as well.

All federal, means-tested welfare programs would be sent back to the states through fixed, finite block grants, just like with the 1996 welfare reforms of just one federal program, the old, New Deal, Aid to Families with Dependent Children program. The reform of that one program was enormously successful, with two-thirds of dependents on the program leaving it to go to work. Studies documented that those who did leave the program for work increased their incomes on average by 25%. But federal taxpayers gained as well, as the program, renamed Temporary Assistance for Needy Families (TANF), cost 50% less than it would have otherwise after 10 years, based on prior trends.

However, there are more than 150 additional federal means-tested welfare programs, all of which can be sent back to the states with fixed, finite block grants, just like AFDC in 1996. The estimated cost of those programs over the next 10 years alone is more than $10 trillion. States would then be empowered to adopt their own entirely new welfare systems as they choose, including a work based safety net that will assure work for the able-bodied poor, like the original Reagan concept of workfare. That would potentially eliminate poverty entirely nationally. Instead of taxpayers paying the bottom 20% of the income ladder nationally effectively not to work, under this reform private employers would pay them more to work, and contribute to the economy, as a mighty wave of increased labor supply that would match the mighty wave of increased capital coming from the personal accounts. That would create an economic boom overall.

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[15] That savings and investment can be required by law as the alternative to a payroll tax that would have to be paid otherwise.

This alone would generate enough savings in government spending to ultimately finance the entire transition to personal accounts. Then there would be the further savings from repealing and replacing Obamacare with free market, Patient Power medicine, and additional savings from positive, populist reform of Medicare, as explained in *Patient Power.* With the transition financed entirely by reduced spending, the personal accounts would produce a massive contribution to national savings and investment, with no offset for increased government borrowing to finance the transition. Altogether, this would amount to the biggest reduction in government spending in world history, with total federal spending as a percent of GDP cut in half from what it would be otherwise.

The workability of this approach was demonstrated by the Ryan Roadmap, the comprehensive legislation introduced in 2010 by the then-House Budget Committee chairman, Paul Ryan, who is now Chairman of the Ways and Means Committee. That proposal included personal accounts for Social Security, fundamental reform of Medicare and Medicaid, general health care reform, tax reform, and other budget reforms. CBO officially scored the Ryan Roadmap as achieving full solvency for Social Security and for Medicare while balancing the federal budget indefinitely into the future, completely eliminating all long-term federal deficits, with no tax increases, and ultimately paying off the national debt entirely. The transition to personal accounts for Social Security was consequently fully paid for, effectively by the spending reductions.

In practice, the transition may be financed by a combination of these two approaches, with some paid for by shorter term federal borrowing, and the rest paid off by long term entitlement reform. This was, in fact, how Chile financed their personal account reforms, through a combination of government borrowing, and reduced government spending.

The net result of all these reforms overall would ultimately be the greatest gain in social welfare in world history.