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The Failed Critique of Personal Accounts

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Even though President Bush's Commission to Strengthen Social Security has yet to produce a specific proposal to establish a personal account option for Social Security, opponents of the idea have already put forward a barrage of objections and criticisms. Those criticisms generally reflect fundamental misconceptions of and confusion about Social Security's current problems. Social Security is facing a financial crisis as early as 2016. The Social Security Trust Fund will not delay the onset of Social Security's problems.

The critics are equally mistaken about individual accounts. Individual accounts do not involve simply switching investments from bonds to stocks. There would be no reduction in survivors' or disability benefits. Although the mix of benefits would change, workers would have higher, not lower, overall benefits under individual accounts. Finally, benefits under the current system are not guaranteed, but workers would have a property right to the funds in their individual accounts.

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Introduction

Even though President Bush's Commission to Strengthen Social Security has yet to produce a specific proposal to establish a personal account option for Social Security, opponents of the idea have already put forward a barrage of objections and criticisms. Those criticisms generally reflect fundamental misconceptions of and confusion about Social Security's current problems and how a personal account option would work.

Five of the most common criticisms follow.

- There is no crisis. Many observers argue that the commission is inventing a crisis where none exists, that warnings of Social Security's financial problems are based on pessimistic assumptions. Others admit that a problem exists but dismiss the commission's assertion that Social Security's financing problem begins in 2016. These critics claim that the bonds held by the Social Security Trust Fund are safe and secure just like the U.S. government bonds held by private pension investment programs, and, therefore, there is no financial problem for Social Security, at least until those trust fund bonds run out.
- What's so great about stocks? Some people suggest that the personal account reform would merely involve shifting retirement investments from the bonds currently held by the Social Security Trust Fund to stocks held in personal accounts, which would not produce any general economic benefits and could not sustain higher benefits across the board.
- Personal accounts require benefit cuts. Some critics deny that a personal account option would reduce the long-term Social Security financing crisis. Indeed, a report by four liberal economists argues that personal accounts would require sharp reductions in Social Security benefits.
- Survivors' and disability benefits are threatened. Many people argue that a personal account option threatens survivors' and disability benefits.
- Guaranteed benefits are lost. Many critics argue that personal accounts would not benefit workers because that option would involve giving up guaranteed Social Security benefits for risky and uncertain personal account benefits.

The evidence shows that each of those critiques is fundamentally flawed.

Is There a Crisis?

One of the commission's most hotly contested assertions is that Social Security faces a financial crisis as early as 2016.[1]

Some critics of the commission's report simply deny that Social Security is facing a financing crisis at all. They assert that the predictions of Social Security's funding shortfall are based on pessimistic assumptions about future U.S. economic growth. However, independent analysis of the trustees' projections, including those of productivity, labor force growth, and longevity, have concluded that the projections are reasonable, perhaps even optimistic.[2] The vast majority of experts on all sides of the debate agree that for Social Security to remain solvent, even in a technical, bookkeeping sense, there would have to be unprecedented levels of economic growth. Moreover, even if the economy does grow more quickly, Social Security's benefit liabilities and its funding shortfalls will eventually rise along with the economy. Therefore, even under assumptions vastly more optimistic than the ones put forward by those who deny that a crisis exists, Social Security still faces trillions of dollars in tax increases or benefit cuts if the system is to stay in balance.[3]

More sophisticated critics concede that Social Security will eventually face a funding shortfall but contend that that shortfall will occur in 2038, not in 2016, and will be much

smaller than the commission predicts. They base this line of reasoning on the existence of the Social Security Trust Fund. For example, economist and *New York Times* columnist Paul Krugman has called the interim report of the president's commission "sheer, mean-spirited nonsense" for citing the 2016 date.[4]

The latest, official projections of the Social Security Board of Trustees estimate that the system will start to go into deficit in 2016. But that's not a problem, Krugman says, because by then the Social Security Trust Fund will have trillions of dollars in government bonds that can be used to continue to pay Social Security benefits for some time.

Such government bonds, Krugman continues, are a "perfectly good asset when they are accumulated by private pension funds," so why aren't they just as good when they are held by Social Security?

The same argument was made in a memorandum recently circulated in the House of Representatives by Rep. Robert Matsui (D-Calif.) addressing personal Social Security account reforms.[5] Matsui touts the $1 trillion in specially issued government bonds held by the Social Security Trust Fund and states that they "will continue to grow in value to $6.5 trillion (in current dollars) by 2024." He adds:

> Those assets were purchased with workers' Social Security taxes and, like every other Treasury bond, are backed by the full faith and credit of the United States government. If they are not real, then are the bonds held by private investors, banks, pension funds and insurance companies not real as well?

Such arguments completely miss the point. The problem was never that the government couldn't be counted on to pay off the government bonds in the trust fund. Rather, the problem is that it is going to be economically quite painful to pay them off.

By Matsui's own account, the federal government will have to redeem $6.4 trillion in Social Security Trust Fund bonds from 2024 to 2038. Exactly where is the money to do that going to come from?

The government could, over that 14-year period, raise taxes by $6.4 trillion, a whopping increase that would surely harm the economy, reducing economic growth as well as burdening taxpayers. Or the government could issue $6.4 trillion in new federal debt—about double the current outstanding federal debt and more than that debt has ever been. Either way, that's a lot of economic pain and suffering over just 14 years.[6]

That is why the Social Security financing crisis starts in 2016 when the system starts to run a deficit and has to start redeeming trust fund bonds to continue to pay Social Security benefits, rather than in 2038 when the trust fund bonds run out. The trust fund bonds represent nothing more than a statement of the legal authority Social Security has to draw funds from general revenues, in addition to payroll tax revenues. But the bonds do not provide such general revenues or even indicate where those general revenues will come from. The actions the federal government will have to take to come up with the money to redeem those bonds will constitute a serious, major burden for the nation's taxpayers and the economy.

Indeed, Social Security itself is not exempt from this burden. To ease the pressure of redeeming trust fund bonds to finance Social Security benefits, the federal government may reduce benefits. After all, it may then be argued that it is only fair that the burden be shared by everyone, instead of having it all borne by current workers. So even payment on the bonds themselves may not be as certain as the defenders of the status quo assume.

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Bonds vs. Stocks

Another major misunderstanding was reflected in a column by *Slate Magazine* editor Michael Kinsley. Writing in the *Washington Post,* Kinsley starts his column by declaring that "the central idea behind the notion of

'privatizing' part of Social Security is that stocks are a better investment than government bonds. If people are allowed to put part of their Social Security payments into shares in private companies, rather than having it all invested for them in U.S. Treasury IOUs (the argument goes), there will be more money available when they retire."[7]

Kinsley goes on to demonstrate the economic illogic behind such an argument. Merely switching investments from bonds to stocks creates no new income or wealth for the nation as a whole. So personal accounts would not be able to sustain higher benefits for workers across the board, as advocates of such reform claim.

But the argument for personal accounts is not based on getting higher returns by switching investments from bonds to stocks. The problem with Kinsley's argument is that Social Security funds are not invested primarily in bonds. Mostly, they are not invested in anything.

Social Security operates on a pay-as-you-go basis. The great majority of funds going into the system each year are immediately paid out in benefits to current beneficiaries. Only the remaining surplus, a small portion of total taxes paid, is given to the federal government in return for government bonds. (If the government uses that borrowed money for increased spending, even the surplus and the resulting trust fund bonds do not represent any sort of real saving or investment.)

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Consequently, Social Security is fundamentally not an investment system but a mere redistribution program. Taxing one group of the population to give money to another produces no real investment income or return at all.

In a private, personal account system, by contrast, the money workers pay in today goes into real, private capital investment. That investment produces returns to the account, which are new income. The new income produced by this capital investment enables the personal accounts to provide far higher benefits than Social Security can pay.

Indeed, the before-tax, real rate of return to capital is around 8.5 percent.[8] Since a pay-as-you-go redistribution system involves no real investment, it produces no return on investment.

Social Security can pay some effective return due to the natural increase over time in tax revenues, which results from increasing wages and population growth. But the return does not involve the generation of new income, so it comes at the direct expense of others. It merely involves taking still more over time from some and giving it to others. In any event, this faux return cannot keep up with the much higher full market capital returns.[9] So pay-as-you-go Social Security benefits in a mature system will naturally fall far behind the benefits that can be paid through a fully funded private system.

The much higher benefits payable through personal accounts, therefore, are the result, not of switching Social Security retirement benefits from bonds to stocks, but of replacing a pay-as-you-go redistribution program that produces and earns no real investment returns with a fully funded investment system that produces and earns full market capital returns.

Benefit Cuts?

Matsui's memo reflects another common theme of the critics: "Plans to allow people to direct part of their payroll taxes into private investments make Social Security's financing problem worse, not better." That is allegedly the case because, if "funds are diverted away from Social Security" and invested in personal accounts, there will be less money to pay future benefits, increasing the long term Social Security financing gap."[10]

Workers who exercise the personal account option will forgo a portion of their future Social Security benefits equivalent to the proportion of Social Security taxes they shift into their personal accounts over their careers. For example, a worker who invested 30 percent of his total Social Security taxes in a personal account each year for his entire

career would forgo 30 percent of his Social Security retirement benefits in return for the much higher personal account benefits, thereby reducing Social Security's expenditures. If all workers did that, the future benefit obligations of Social Security would be reduced by roughly 30 percent overall.[11]

A personal account option for Social Security would consequently eventually reduce or eliminate the program's long-term financing gap in proportion to the extent to which workers exercised that option. If all workers exercised the option to shift 100 percent of their payroll taxes into personal accounts, eventually the current Social Security system would be replaced entirely by personal accounts, and (once the transition was completed) the long-term financing gap of the current system would be eliminated entirely as well. If half of all workers shifted 100 percent of payroll taxes to personal accounts, eventually Social Security expenditures and the long-term financing gap would be reduced by roughly half. A personal account option, therefore, provides a means to reduce or even eliminate completely the long-term Social Security financing gap, without raising taxes or cutting benefits.

Until the long-term expenditure savings due to personal accounts are achieved, transition financing will be needed to replace payroll tax funds devoted to personal accounts. This transition financing can start with the current Social Security surpluses.

Once those surpluses end, general revenues will be needed to help to continue to pay all promised Social Security benefits during the transition phase. Advocates of personal accounts have long recognized that general revenues would be needed for the transition.[12] As personal accounts ultimately reduce Social Security expenditures, the need to use general revenues will be reduced and ultimately eliminated.

There are many possible sources of the needed general revenue, including reductions in wasteful and unnecessary government spending, projected budget surpluses, and borrowing. Moreover, the personal accounts themselves would help to pump up general revenues. As Martin Feldstein has emphasized, any new investment through the accounts would increase tax revenues due to taxation at the business level of the new before-tax returns generated by that investment.[13] Over time, that would likely produce quite substantial revenue increases. The increased general economic growth likely to result from the reform would further add to revenues. Indeed, Feldstein estimates that the present value of the net economic gain from shifting entirely to personal accounts would be $10 trillion to $20 trillion.[14]

Modest restraints on general federal spending over the years would free substantial general revenues for the transition. A small part of the transition financing burden, especially in the earlier years, can be financed simply by issuing new general federal bonds. Those bonds can be paid off later from the net surpluses generated once the transition is completed. Workers who exercise the personal account option can also be required to make some continuing payroll tax contribution for the transition. All those sources of transition financing are discussed in more detail in *A New Deal for Social Security*.[15]

The most widely cited allegation that individual accounts would force reductions in Social Security benefits is contained in an analysis by four longtime opponents of personal accounts, Henry Aaron, Alan Blinder, Alicia Munnell, and Peter Orzag.[16] Those analysts insist that allowing just two percentage points of the payroll tax to be diverted to individual accounts would require future Social Security benefit cuts of about 30 percent for those who will be 50 years old next year and 54 percent for those who will be 30 or younger.

Even counting the retirement income they expect from personal accounts, the authors argue that total future retirement benefits for single average-income workers who will be 30 years old next year would be 20 percent less than the benefits they are promised by the current system. For workers

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Table 1
First Year's Payments from Personal Account as Percentage of First Year's Social Security Benefits under Current Law

Year of Retirement at Age 65	Career Contribution Level					
	1% of Pay	2% of Pay	3% of Pay	1% of Pay	2% of Pay	3% of Pay
	At 6% Annual Return			At 10% Annual Return		
2010	1.7%	3.3%	5.0%	1.9%	3.9%	5.8%
2020	4.1%	8.3%	12.4%	5.8%	11.6%	17.3%
2030	7.5%	15.0%	22.4%	12.9%	25.8%	38.6%
2040	11.1%	22.2%	33.3%	24.1%	48.2%	72.2%
2050	13.1%	226.1%	39.1%	31.9%	63.9%	95.8%
2060	12.8%	25.7%	38.5%	31.4%	62.8%	94.2%
2070	12.6%	25.2%	37.9%	30.9%	61.8%	92.6%

Source: David Koitz, Geoffrey Kollmann, and Dawn Nuschler, "Social Security: What Happens to Benefit Levels under Various Reform Options," Congressional Research Service, August 20, 2001.

Feldstein estimates that the present discounted value of the net gain to the American economy from shifting to fully invested personal accounts would be $10 trillion to $20 trillion.

who will be 50 next year, the personal accounts would just barely replace the Social Security benefit cuts.

But the authors reach those conclusions by fundamentally misstating the evidence, comparing apples and oranges as it were. Their results include not just the benefit cuts they believe would be necessary to offset the revenue lost due to the personal account contributions but also the benefit reductions that would be necessary to completely eliminate the entire current long-term Social Security financing gap. The authors are disingenuously falsely blaming the deficits of the current program and the losses they imply on personal accounts.

President Bush has never said that he would cut Social Security benefits to address Social Security's long-term financing deficits. Even if he did, that would have nothing to do with personal accounts. Aaron et al. are comparing a financially balanced system containing individual accounts with benefits provided under current law. But as Charles Blahous, the president's commission's executive director, has pointed out, "The essential problem with comparing reform plans with 'current law' is that 'current law' allows the system to go bankrupt."[17]

In addition to conjuring up phantom allegations of benefit cuts, Aaron and his coauthors make two additional errors. First, they count only a small fraction of the full market investment returns that would be produced by personal accounts. New investment in the accounts would produce the full, before-tax, real rate of return to capital, which is about 8.5 percent or more, rather than the 3 percent real return that may be earned by quite secure bonds.

Second, the authors fail to consider the major increases in new income and economic growth that would result from a properly designed and executed personal account option. As indicated above, Feldstein estimates that the present discounted value of the net gain to the American economy from shifting to fully invested personal accounts would be $10 trillion to $20 trillion. Consequently, by failing to consider those effects, Aaron and his coauthors leave a $10 trillion to $20 trillion hole in their analysis.

In reality, individual accounts will likely provide workers with higher overall benefits

in retirement. For example, a recent study by the Congressional Research Service shows that, for workers retiring in 2030, an account equal to 2 percent of pay would provide the equivalent of 25.8 percent of promised Social Security benefits.[18] For an individual retiring in 2050, a 2 percent account would provide the equivalent of 62.8 percent of promised Social Security benefits (Table 1).

The accumulation in individual accounts would offset not only benefit reductions due to the individual accounts but also any additional changes in benefits needed to restore the program to long-term solvency. What matters to retirees, after all, is not where the benefits come from—government or individual accounts—but the final size of their benefit check. In the end, individual accounts can provide benefits far better than the system can currently pay, and likely better than what the system currently promises.

Survivors' and Disability Benefits

Matsui and many others also insist that a personal account option for Social Security would threaten the program's survivors' and disability benefits. His memo states that Social Security benefits "for the families of disabled or deceased workers . . . are among those that are most threatened by substituting private accounts for current Social Security."[19]

But Bush has said from the very beginning that the personal accounts would not involve or affect disability or survivors' benefits. Not only was the president's commission charged with maintaining survivors' and disability benefits, but cochairman Daniel Patrick Moynihan has said, explicitly: "In no circumstances will disability benefits, survivors' benefits be touched. We won't even approach the question."[20]

Those benefits would continue to be provided by Social Security, with no change due to the personal account reform. People who support a personal account option have also consistently accounted for the continuation of those benefits, either by continuing to provide them through Social Security as today or by providing them through private insurance. Every foreign country that has moved to personal accounts has done the same. The issue is just not honestly on the table.

Guaranteed Benefits

A final refrain is that a personal account option would involve workers' giving up a guaranteed benefit in return for uncertain and risky benefits from personal accounts. This argument could not be more wrong.

First, Social Security benefits are not guaranteed. The Supreme Court ruled in the case of *Flemming v. Nestor* that Social Security benefits are not backed by a government guarantee and that Congress is free to reduce them or even cut them off for any or all workers at any time.[21]

Moreover, given the long-term Social Security financing crisis, the only guarantee in the program is that currently promised benefits will not be paid in the future. With Social Security so badly underfunded over the long run, currently promised Social Security benefits are far more risky than would be the expected benefits from a personal account investment program.

Moreover, the potential risk of personal account benefits is mitigated by the enormous gulf between the likely benefits from those accounts and promised Social Security benefits. For most young workers today, even if all promised Social Security benefits are somehow paid, those benefits will still only represent a real rate of return on the enormous taxes paid by workers and employers over their careers of around 2 percent or less. For many it would be zero or even negative.[22]

By contrast, the long-term real return in the stock market has been around 7.5 to 8 percent, and the real return on corporate bonds has been around 3 percent or more.[23] Yet, at a real return of just 4 percent, workers would receive through the personal accounts

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close to three times the benefits promised by Social Security.[24] There is no real chance that private market returns and benefits would fall below even the promised Social Security returns and benefits that we know the system can't pay. So all that Social Security today truly guarantees you is a bad deal.

Finally, the personal account system will have a government guarantee of benefits. Every country that has adopted a personal account system has included a guaranteed minimum benefit. Advocates of personal accounts in the United States have consistently supported such a guaranteed minimum benefit as well.

Indeed, in our 1998 book, Michael Tanner and I proposed a guaranteed minimum for workers with personal accounts equal to the average benefit paid by Social Security.[25] Lower-income workers would consequently be guaranteed a higher benefit than promised them by Social Security today. That guaranteed minimum benefit would provide a better social safety net than Social Security does. Such a generous guarantee is feasible because personal accounts would likely provide benefits so much higher than would Social Security. Given this large margin for error, it is quite unlikely that workers would fall below the minimum. A guaranteed minimum benefit along these lines has worked well in Chile for 20 years now, with few or no claims against it.

Conclusion

Despite all the heated criticism directed at President Bush's Social Security Commission and a possible personal account option for Social Security, the critics have failed to raise a convincing objection to such an option. Most of the criticisms have been based on simple misunderstandings and misinformation.

Indeed, informed observers of the debate must be left wondering why the critics are, in fact, opposed to a personal account option. All valid concerns have been addressed. Working people would end up with higher benefits, and the Social Security financing gap would ultimately be reduced or even eliminated. Lower-income workers, minorities, women, and blue-collar workers would in many ways benefit the most.

As columnist Jonathan Rauch puts it:

> One way or another, 25 years from now Americans will take for granted the ability to manage part or all of their Social Security investments. . . . Moreover, they will cherish these choices and feel allegiance to whichever party they think bestowed them.[26]

This is just another battle between true progressive liberalism and the reactionary status quo. It is long past time for the self-styled progressives to join the truly progressive side.

Notes

1. *Interim Report of the President's Commission to Strengthen Social Security,* July 2001, http://www.csss.gov/reports.

2. See, for example, Pricewaterhouse Coopers, "Report on the Actuarial Projections of the Social Security Trust Funds," in General Accounting Office, *Social Security Actuarial Projections* (Washington: Government Printing Office, January 14, 2000); and 1999 Technical Panel on Assumptions and Methods, "Report to the Social Security Advisory Board," November 1999.

3. For a detailed discussion, see Andrew Biggs, "Social Security: Is It 'A Crisis That Doesn't Exist'?" Cato Institute Social Security Paper no. 21, October 5, 2000.

4. Paul Krugman, "2016 and All That," *New York Times,* July 22 2001.

5. Robert T. Matsui, Memorandum to Democratic Members of the U.S. House of Representatives, July 10, 2001.

6. The government could, of course, cut other spending, but that is politically unlikely.

7. Michael Kinsley, "Social Security: Taking Stock," *Washington Post,* July 27, 2001.

8. James Poterba, "The Rate of Return to Corporate Capital and Factor Shares: New Estimates Using

Revised National Income Accounts and Capital Stock Data," National Bureau of Economic Research, April 1999, pp. 9–10. See also Martin Feldstein, Louis Dicks-Mireaux, and James Porterba, "The Effective Tax Rate and the Pre-Tax Rate of Return," *Journal of Public Economics* 21 (July 1993): 12–58.

9. For further discussion, see Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998) pp. 61–64.

10. Matsui, pp. 3–4.

11. I refer here to the portion of Social Security and its deficit relating to the program's retirement benefits. As discussed below, President Bush has already indicated that, under his proposed reforms, Social Security's survivors' and disability benefits would continue to be paid by the government as they are under current law. But the same analysis would be applied to those benefits and the long-term gap in their financing if the personal account option provided for private life and disability insurance to replace Social Security survivors' and disability benefits, as has been done in Chile and other countries.

12. See, for example, Ferrara and Tanner, chap. 9.

13. For a fuller discussion of that taxation, see ibid., pp. 180–81.

14. Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," *American Economic Review* 86 (May 1996): 12. See also Martin Feldstein, "Privatizing Social Security: The $10 Trillion Opportunity," Cato Institute Social Security Paper no. 7, January 31, 1997.

15. See Ferrara and Tanner, chap. 9.

16. Henry Aaron et al., "Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," Century Foundation Issue Brief no. 11, June 2001; and Henry Aaron et al., "A New Analysis of Governor Bush's Individual Account Proposal: Implications for Retirement Benefits," Century Foundation Issue Brief, October 16, 2000.

17. Charles P. Blahous, *Reforming Social Security for Ourselves and Our Posterity* (Westport, Conn.: Praeger, 2000), p. 140.

18. David Koitz, Geoffrey Kollmann, and Dawn Nuschler, "Social Security: What Happens to Benefit Levels under Various Reform Options," Congressional Research Service, August 20, 2001.

19. Matsui, p. 3.

20. Quoted in Adam Clymer, "Social Security Panel Says Cuts in Benefits Are an Option," *New York Times,* August 25, 2001.

21. 363 U.S. 603 (1960). See Charles Rounds, "Property Rights: The Hidden Issue of Social Security Reform," Cato Institute Social Security Paper no. 19, April 19, 2000.

22. Ferrara and Tanner, pp. 65–72.

23. Ibid., pp.72–74.

24. Ibid., pp. 74–85.

25. Ibid., pp. 172–73.

26. Jonathan Rauch, "A New Center Beckons, But Can Either Party Find It?" *National Journal,* June 16, 2001.

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