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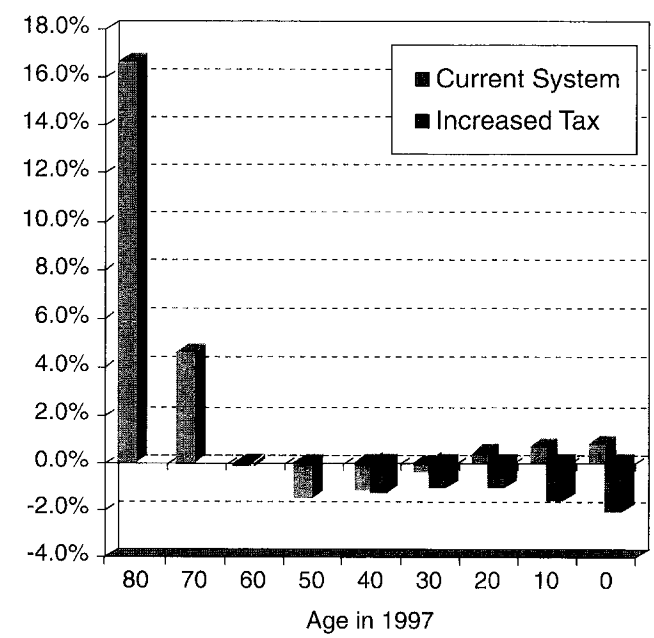
Social Security Becomes Increasingly Bad Investment for Baby Boomers

With baby-boom retirement looming on the horizon, most policymakers recognize the financial trouble Social Security faces, but the pending insolvency of the federal system is only half of the story. The other half, as Senior Economist Arthur Hall points out in his latest *Special Report*, is that most future retirees can expect to lose money on Social Security when it is evaluated as an investment program for retirement.

Chart 1: Social Security Rate of Return for Avg.-Wage Couple
Current Payroll Tax v. Potential Increased Payroll Tax



Source: Tax Foundation.

Consequently, says Dr. Hall, the challenge of reforming Social Security is not simply to restore solvency to the system. Reforms undertaken with solvency as the only goal — including raising payroll taxes, as Chart 1 illustrates — will make Social Security an even worse retirement program for future retirees. The challenge is to devise a reform program that simultaneously honors the promises made to retirees and offers today's working population a better financial future.

In his "Primer on Social Security Reform," Dr. Hall observes that the pay-as-you-go nature of the Social Security transfer program helps explain its current political popularity as well as its looming bankruptcy. Because there has never been a clear link between the Social Security "contributions" paid and the benefits received, workers retiring before the early 1980s received benefits based on their highest lifetime wage levels but faced relatively low lifetime payroll tax rates — and, in many instances, paid no payroll taxes for a large fraction of their working life. Consequently, retirees up until the early 1980s received substan-

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Social Security an Increasingly Bad Investment

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tial inflation-adjusted rates of return on their employer/employee payroll tax payments.

These high rates of return began to fade away, as policy changes in the 1970s and 1980s increased the cost of Social Security one way or another — whether by paying lower benefits for the same contributions or by paying the same benefits for higher contributions.

Chart 1 illustrates two concepts: First, it shows the dramatic decline in inflation-adjusted rates of return for new and future retirees under the current law, as described in the preceding paragraphs. Second, Chart 1 demonstrates that any reforms designed to repair the solvency of the Social Security program through higher taxes or lower benefits will make the program an even worse retirement program for current workers than it already is.

For example, a couple that retired in 1982 (age 80 in 1997) received a 16.58 percent return on their employer/employee payroll taxes (after compounding these tax payments with interest to reflect the opportunity cost of foregone private investments). In contrast, a couple at age 50 in 1997 (retiring in the year 2013) can expect to receive a return of -1.55 percent on the payroll taxes they and their employer(s) paid. The returns remain negative for most of the baby-boom generation couples that fit the average-wage earner profile.

(Dr. Hall's analysis shows that the rate of return turns positive again for the hypothetical average-wage couple that is age 25 or younger in 1997. This is a result of the interaction of current-law payroll tax rates, growing wage levels, and longer life spans. However, he notes, the current Social Security system is clearly not financially viable with the combination of current-law payroll tax rates and the current benefit structure.)

Chart 1 also shows that when payroll tax rates are increased sufficiently to keep Social Security solvent (according to the 1996 intermediate "cost basis" actuarial assumptions of Social Security's Board of Trustees), the rate of return on Social Security payroll taxes turns negative for all couples age 60 or less in 1997.

Another way to understand how bad an investment Social Security will be for baby boomers, observes Dr. Hall, is to compare couples' expected annual after-tax Social Security benefits with a hypothetical after-tax annuity that they could have purchased with their lifetime employer/employee payroll taxes. The figures in Chart 2 demonstrate that every couple of the baby-boom generation would have been much better off financially if their payroll taxes had been placed in an interest-bearing account rather than immediately paid out to Social Security recipients.

For example, low-wage couples retiring in the year 2012 can expect to receive $27,370 in inflation-adjusted, after-tax benefits each year. Their hypothetical annual annuity, however, would have amounted to $30,504, a $3,134 per-year increase. More importantly, under the hypothetical annuity arrangement, the full value of the annuity (and its underlying principal) would remain in the couples' estate in the event of an untimely death, or deaths. Under Social Security, the cashflow sim-

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Chart 2: Comparison of Annual Social Security Benefits with a Hypothetical Annual Annuity for Low-, Average-, and High-Wage Couples of Varying Ages

		Low Wage Couple		Average Wage Couple		High Wage Couple	
Year of Retirement	Worker's Age in 1997	Annual After-Tax S.S. Benefits	Hypothetical Annual After-Tax Annuity	Annual After-Tax S.S. Benefits	Hypothetical Annual After-Tax Annuity	Annual After-Tax S.S. Benefits	Hypothetical Annual After-Tax Annuity
2012	51	$27,370	$30,504	$37,153	$46,367	$50,103	$70,082
2015	48	31,666	35,267	42,978	53,357	57,981	80,222
2019	44	38,402	42,488	52,118	63,030	70,333	93,975
2023	40	45,081	50,225	64,663	77,636	87,250	114,580
2027	37	53,522	60,432	76,879	92,872	103,550	136,040
2031	33	65,107	70,638	93,439	107,379	125,872	158,121

Note: Hypothetical after-tax annual annuity totals are based on a hypothetical scenario where lifetime employee/employer Social Security contributions are placed in an annuity and compounded with interest, under current payroll tax law.
Source: Tax Foundation.

Policy Experts Say Social Security Reform Has Future — But Will National Policymakers Agree?

Reforming Social Security, even to the minimal degree that a federal panel of experts recently proposed, won't be easy politically. But to the group of public policy experts gathered to discuss the issue of reform at the Tax Foundation's 59th national conference in New York City, not only is such reform necessary — it's actually feasible.

While some congressional leaders in Washington is that Social Security privatization is a "nonstarter," others generally favor the concept. Rep. Nick Smith (R-Mich.), whose own bill last term would have provided for "personal retirement savings accounts," kicked off the Tax Foundation's half-day conference November 21 with a luncheon address that painted a grim picture of Social Security's future under current law. Likening the program to a Ponzi scheme, Rep. Smith observed that in 1937, 42 people worked for every Social Security recipient. In subsequent years, though, fewer and fewer people were paying for more and more Social Security beneficiaries. Today, only 3.3 workers are expected to support each beneficiary, whose average lifespan is far greater than it was back in 1937.

Cato Institute's Michael Tanner explains a point during his panel discussion while Tax Foundation Senior Economist Arthur Hall listens.

Dr. Ricardo Zabala, an expert on the Chilean reform experience, makes a point during his panel's question-and-answer period as Dr. John Goodman looks on.

Following Rep. Smith, Citizens for a Sound Economy Communications Director Brent Bahler unveiled the results of a nationwide survey of Americans. CSE's election-night survey of 1,200 adults found that 92 percent of respondents agreed that "Social Security is in need of serious reform if it is going to remain financial healthy for those currently on it and those counting on it in the future." Over 80 percent said Congress should make reform a top priority in the next two years. At the same time, a bare majority agreed that workers should be able to take their employee-employer Social Security contributions and invest it in a private institution. Over a third of respondents felt such a policy would be too risky.

Three panel discussions followed in the afternoon:

• "Problems and Promises," with Michael Tanner, Director of Health and Welfare Studies at the Cato Institute, and a response by Dr. Arthur Hall, Senior Economist at the Tax Foundation.

Mr. Tanner laid the groundwork for other panelists by exploring Social Se-

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Rep. Nick Smith (R-Mich.) kicks off the 59th national conference in New York with a luncheon address on "The Entitlement Crisis."

CSE Communications Director Brent Bahler explains the results of his group's Election Day national opinion survey on Social Security reform.

Public Economic Policy Fallacies

By Dr. Norman B. Ture

Dr. Norman B. Ture, founder and president of the Institute for Research on the Economics of Taxation, received the Distinguished Tax Policy Service award from the Tax Foundation at the 59th Annual Dinner in New York City. Following are excerpts from his acceptance remarks.

J.D. has asked me to relate briefly what I have learned in the many years I've spent writing about, talking about, worrying about public economic policies, and I'm pleased to do so. Before I get into substance, however, I want to acknowledge the debt I owe to so many of you in this audience with whom I have had the opportunity to exchange ideas over the years. The single most important positive thing I have brought away from these discussions is the conviction that private businesses are the prime mover of economic progress in our society, indeed, in all free societies. It is a viewpoint that has enormously helped me to assess the goodness or badness of policy initiatives.

Is it credible that public policy makers can obtain that information and use it effectively in policy formulation? To believe so is to perceive the American economy as a marionette controlled by bureaucrats pulling on policy strings. It is a fiction, dear to the hearts of elitist policy wonks, but without basis either in fact or analysis.

I have learned a great many other things during my labors, aided and abetted by the many colleagues I have had at IRET. It occurs to me that the most important things I've learned are things that aren't so — the fictions of public economic policy. Let me share with you only a few of them in the hope that if you have believed them, you no longer will, and if you haven't believed them your skepticism will be fortified by these observations.

The economy's performance depends on how well government manages the economy.

This fiction is almost universally believed to be gospel truth. It's a view shared by arch conservative Republicans and far-left Democrats, as well as all but a handful of other people. Think how often during the recent political campaigns we were told that Clinton had done a good job of managing the economy or that he had done a poor job and Dole would do a better one. Our Democrat friends pointed to the uninterrupted growth in GDP and employment and low inflation during the past four years and asserted or at least strongly implied that it was the Administration's policies that produced these very nice results. Republicans, on the other hand, insisted that the GPD growth in the Clinton years was the slowest in you-fill-in-how-many-years and that Administration policies were responsible for this inadequate performance.

I am convinced that public economic policies influence economic outcomes, but I am also convinced that influence is marginal, at most, and very poorly perceived. Comparing the economy's performance over a given period with that of a prior period is grossly misleading; to assess the effects of public policies, we need to compare actual economic performance with what it would have been in the absence of those policies. Any volunteers for that task?

Think of it: the U.S. economy is the largest, most diversified economy of all time and place. Its operations occur in the most advanced markets ever known, markets that every moment cast up incredible amounts of information to guide business and household decision-making behavior. Is it credible that public policy makers can obtain that information and use it effectively in policy formulation? To believe so is to perceive the American economy as a marionette controlled by bureaucrats pulling on policy strings. It is a fiction, dear to the hearts of elitist policy wonks, but without basis either in fact or analysis.

The market system is frail and imperfect, given to instability that requires government intervention and management.

This is one of the fictions, part of longstanding socialist doctrine, that

provide the rationale for government's efforts to manage the economy. To be sure, market operations in an economy dynamic as that of the United States can't and shouldn't be expected to produce GDP, employment, and income growth paths that never depart from trends. For one thing, the United States has an open economy, subject to shocks that originate in other parts of the world. These shocks require adjustments by businesses and households, and these adjustments are likely to result in some departures, generally of short duration, from stable growth trends.

Another source of such departure is the entrepreneurial zest and activity resulting in product and production process innovations that render existing products and processes obsolete. The result is likely to be dislocations, shifts in the demands for and uses of production inputs that sometimes, happily infrequently, take significant parts of the economy off of established growth paths. Government intervention to prevent such results could succeed only by raising the cost of risk taking, innovation, and entrepreneurship generally.

By far the most important private sector source of economic instability is failure by households and businesses to respond fully and appropriately to changing economic circumstances. Economic activity depends on information; the greater is the amount of information and the greater the speed with which it becomes available to decision makers, the more efficiently is the economy likely to perform. Information is not costless, however, nor are the adjustments of economic behavior that are called for by a correct reading of information.

Because the U.S. economy is so dynamic and because the market system is so efficient, an enormous amount of changing information is presented to economic players every minute. For the most part, we react promptly and to our best advantage. We often, however, mistake the market's signals or respond inappropriately to them. Sometimes, for example, enough of us stay too long at the capital formation well and do not promptly foresee the decline in the net real return on our savings and the stock of capital in which our savings are invested. When we ultimately recognize our errors and slow the pace of capital formation, the resulting decrease in output may be enough to tumble us into recession. (Parenthetically, another public policy fiction is that departures from trend of consumption outlays lead us into recession and recovery; in fact, changes in capital formation are the prime movers.)

If government is to stabilize the economy, policymakers must have better information than the market system provides, must know better than market participants how businesses and households should adjust their activities, and guide market participants into making those adjustment on a timely basis. Does anyone believe that public policymakers or government bureaucrats have better information, have it sooner, and interpret its significance better than private sector market participants?

Government can and should use its tax and spending powers to reduce differences in the distribution of income.

Everyone who works in the public economic policy field knows that the bottom line with respect to virtually any public economic policy or initiative are the questions, "Who gets the benefits and who pays the bills?" You all know the media spoof: "Massive meteor about to destroy planet earth — minorities and the poor to suffer most." It's the same mind set that besets economic policy. Very bad changes in the tax laws can be enacted on the basis that they will reduce the tax burden on the so-called poor, while very constructive tax changes can be blown away by the assertions that the "rich" will be the principal beneficiaries. People afflicted with this view disregard the basic idea, embodied in our constitutional principles, that all individuals should stand equally before the law. They also disregard the economic record that shows that despite an ever more redistributive fisc, the statistic that measures disparities in the distribution of income and wealth has not changed over very long periods of time. Finally they disregard what rudimentary economic analysis shows: because efforts to reduce distributional differences entail increasing the tax burden on the returns to capital while reducing those on the returns to labor, the stock of capital will be less than it otherwise would be and the pre-tax return on capital will therefore be higher, while the reverse will be true for labor returns. The mean old market system will make adjustments that very largely cancel fiscal actions, and the distribution of income is little affected by redistributionist public policies. In the meantime, of course, these policies have added to the government-induced distortions of market signals and impaired productivity.

Several years ago I challenged the then-Secretary of the Treasury whether he'd rely on the assertion that the earth is flat in recovering an astronaut returning from a space mission. His response was that as long as the people, particularly the financial community, relied on this view, he'd have to go along. Too bad for the astronaut and in the real life case, too bad for those businesses that had formulated their investment programs on the assumption that taxes wouldn't be increased. Fictions, no matter how widely entertained, are a bad basis for formulating public policies. •

Policy Experts Say Social Security Reform Has Future — But Will National Policymakers Agree?

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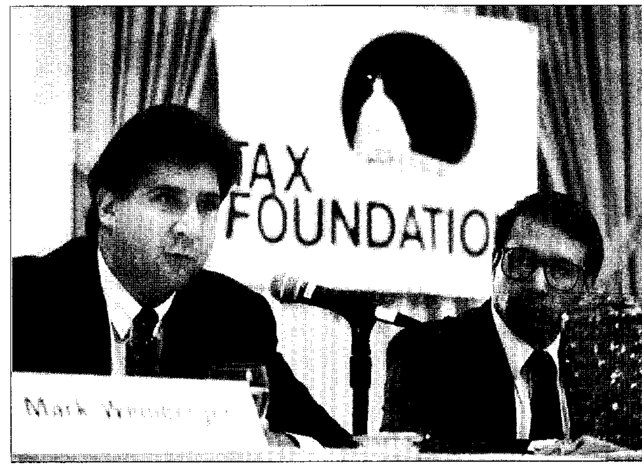

Attorney Mark Weinberger responds to a question as IRET's Stephen Entin looks on during their panel discussion on "Options for Reform."

curity's fiscal crisis. The beginning of the end starts in 2012, he said, when the program will start paying out more in benefits than will receive in revenue. Worse yet, if the country experiences a major recession in the next decade, the date for insolvency could arrive much earlier.

Dr. Hall explained, in his response, that any traditional governmental solution to Social Security's imminent insolvency — whether raising payroll taxes or lowering benefits — will only make the problem worse for future retirees. As it stands today, if Social Security is treated as a retirement investment, baby boomers are earning negative rates of return. A tax hike or benefit reduction would only make this rate of return worse, according to Dr. Hall's analysis.

- "Learning from Chile," with Dr. Ricardo Zabala of Citibank, N.A., in Santiago, Chile, with a response by Dr. John Goodman, President of the National Center for Policy Analysis (NCPA).

Dr. Zabala examined the Chilean experience, with its "public social security system that is privately managed," contrasting it with the rest of Latin America. Chile was the first Latin American nation to undertake private pension system, but most of the nations of that region have either implemented similar plans now or have plans to start such a program. To date, 87 percent of the Chilean labor force has "opted out" of the government retirement system in order to participate in the private pension system. In the 15 years since Chile launched its progressive program, the rate of return has averaged 12.7 percent over inflation. In addition, Chile now boasts the highest rate of savings in Latin America, 28 percent of Gross Domestic Product.

Dr. Goodman reminded the audience Social Security is not the only program that is pay-as-you-go — the entire federal entitlement structure is built along these lines. Hence, we cannot look at the Social Security crisis in isolation, because the same payroll tax that funds Social Security also funds Medicare, which will ultimately claim a larger share of federal funds than Social Security. By 2040, for every dollar the government spends on Social Security, analysts project \$1.50 will be spent on Medicare and another 50¢ will be spent on other federal health care programs.

- "Options for Reform" with Stephen Entin, Resident Scholar at the Institute for Research on the Economics of Taxation (IRET), with a response by Mark Weinberger of Washington Counsel, P.C.

Mr. Entin outlined the choices that policymakers in Washington face in an effort to ensure that future retirees are not left in the lurch. He compared the current tax transfer system with a "funded" system — noting that there is no saving involved in the former while the latter does included saving. He also explored issues policymakers will have to deal with (e.g., how much of an individual's retirement investment should be "privatized"? should investment options be limited? how much should workers be forced to save?). Ultimately, said Mr. Entin, transitioning from the current system to a new system will be very difficult and costly.

1996 Tax Foundation award recipients Rep. Phil Crane and Dr. Norman Ture share a private chat prior to the annual dinner at the Waldorf-Astoria.

Mr. Weinberger observed that the Social Security Quadrennial Advisory Council will release its report in 1997 suggesting ways to resolve the problem. Reportedly, the Council will propose solutions outside the traditional fixes of tax hikes and benefit cuts. These plans will include investing a portion of payroll taxes in the marketplace rather than Treasury bonds; a 1.6 percent mandatory savings program on top of Social Security, which would go into private accounts while being managed by the federal government; and a five percent reduction in payroll taxes, with the reduction being switched over into private accounts.

At the Annual Dinner, Dr. Norman Ture, founder and president of the Institute for Research into the Economics of Taxation (IRET) was honored with the Tax Foundation Tax Policy Service Award, for his four decades of work on behalf of sound tax policy. (See Dr. Ture's remarks in this issue's *Front and Center.*) Rep. Philip M. Crane (R-Ill.) was the recipient of the Foundation's Distinguished Service Award.

FOUNDATION MESSAGE

J.D. Foster
Executive Director
& Chief Economist

Early Jingles in Social Security Reform

The President's advisory council on Social Security reform has released its report. Tasked two years ago with devising a blueprint for reform, the council exceeded itself and devised three. If Washington's ethics wars don't become too consuming, the council's report should establish Social Security reform on center stage of the national debate.

The first plan advanced by the council was dubbed the "Maintenance of Benefits" (MB) plan, though a "Tax and Tinker" label might have been more appropriate. Among other things, it suggests an increase in income taxes on Social Security benefits, a future redirection of funds from the Hospital Insurance (HI) Trust Fund into the Old-Age, Survivors, and Disability (OASD) Trust Fund, a future payroll tax increase, and "serious consideration" of allowing the government to invest some portion of payroll tax receipts in the stock market.

For Social Security reform to succeed,... it must must offer today's workers a chance to enjoy a market-based return on a greater share of their pension saving.

The second plan was labeled the "Individual Accounts" plan. This plan also involves an increase in the income taxation of benefits, an acceleration of the already-scheduled increase eligibility age, and a reduction in the growth of retirement benefits primarily affecting middle- and upper-income workers. In addition, the plan calls for an increase in the payroll tax of 1.6 percentage points to fund individual defined contribution accounts. As the council points out, if the individual invests these funds wisely, then the returns from these accounts plus their scaled-back Social Security benefits should leave most workers with the same retirement in income as they are currently promised. This could more accurately have been called the "Pay More, Get No More" plan.

The third plan is called the "Personal Security Accounts" (PSA) plan. Under this plan, workers would direct five percentage points of their current payroll tax into a PSA, which would be privately managed. The balance of the payroll tax would fund a flat-dollar benefit retirement program and modified disability and survivors benefits. This plan also increases income taxes on benefits, accelerates the increase in eligibility age, reduces future benefits for some individuals, and levies a payroll tax increase equal to 1.52 percent of payroll.

Further, this plan would increase the federal budget deficit. According to the council, workers would on average have more retirement income under the "Personal Security Accounts" plan than under the current system.

Giving individuals control of five percentage points of their payroll tax to invest as they see fit is virtually equivalent to a tax reduction of like amount unless the taxpayer would choose to spend part of it or invest it in ways not allowed under the PSA. Many taxpayers, however, save privately to supplement whatever Social Security benefits they expect to receive. With confidence in their ownership of the PSA, as opposed to a lack of confidence in Social Security, they would likely reduce their other private saving activities. In other words, for most taxpayers there would be very little difference between a pure tax cut of five percentage points of payroll tax, and personal control over this amount through the PSA.

Assuming the suggested income tax increases on Social Security benefits are minor, once the 1.52 percent of payroll tax increases is netted against the control granted taxpayers over five percentage points of their current payroll tax, taxpayers almost certainly receive a tax cut under this plan, in effect if not in name. By returning control of a significant share of payroll taxes back to workers, this third plan could well have been labeled the "Do-It-Yourself" plan.

The Congress can take many paths to assure the fiscal soundness of Social Security. Some might even be politically feasible. Most of them, however, would exacerbate the terrible investment most baby-boom retirees now confront, as demonstrated in Senior Economist Arthur Hall's latest analysis [see page 1].

For Social Security reform to succeed, it must offer taxpayers some compensation for the loss of promised benefits and, under some plans, the proposed tax increases. It must offer more than a greater degree of confidence that Social Security will be able to pay whatever remains of the promised benefits. Reform must offer today's workers a chance to enjoy a market-based return on a greater share of their pension saving. The "Do-It-Yourself" plan may not have all the answers, but it, at least, offers a reasonable chance of rebuilding a justified confidence in the Social Security system. •

Social Security an Increasingly Bad Investment

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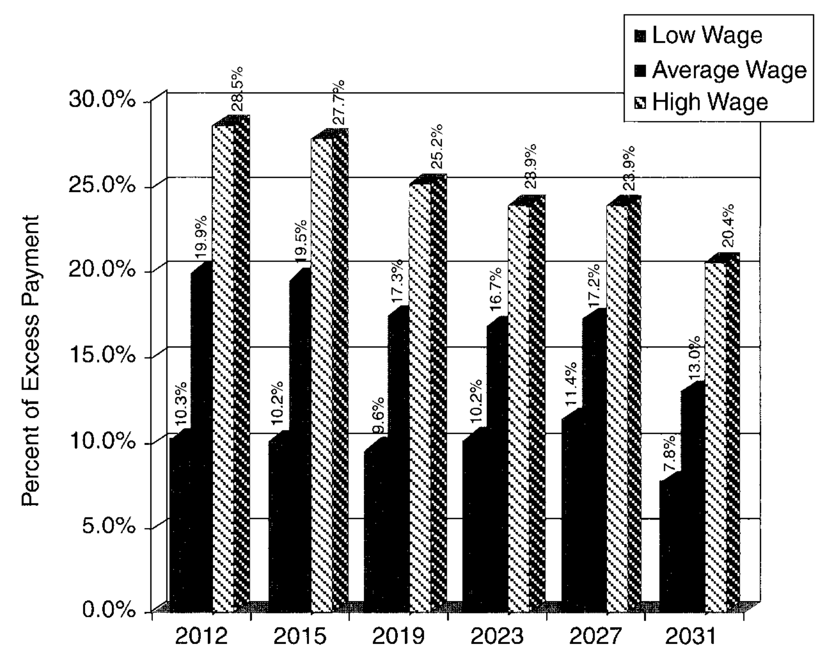
ply stops for the deceased and survivors have no claim to any amount of principal.

(The annuity values in Chart 2 are based on the relatively low interest rates earned on Social Security Administration special-issue bonds. With market rates of interest on private securities, the hypothetical annuities would be substantially larger than those reported.)

Finally, Chart 3 provides calculations showing how much the baby-boom generation will be forced to "overpay" over an entire career for its Social Security retirement benefits, given current payroll tax rates. Here, Dr. Hall has calculated the percentage difference between what low-, middle-, and high-wage couples *will* pay for their benefits and what they *would have* paid to receive the same benefits had they invested in a private annuity.

For example, an average-wage couple retiring in the year 2015 will pay $178,651 "too much" for its expected Social Security benefits. The 13 different employer/employee payroll tax rates that the husband and wife have faced and will face over their lifetime under current law will have averaged 19.45 percent higher than if their contributions had gone into an annuity. While their after-tax Social Security benefits will total $918,443, an after-tax annual annuity equal in value to this would have cost the couple only $739,792.•

Chart 3: Excess Payroll Taxes Paid by Baby-Boom Couples



Source: Tax Foundation.

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