

SPECIAL BRIEF

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Reforming Social Security *House Ways & Means Committee Testimony*

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Mr. Chairman, Members of the Committee, it is with great pleasure that I appear before this Committee to testify to the importance of reforming the Social Security program.

I am the Executive Director and Chief Economist of the Tax Foundation. The Tax Foundation is a 62-year-old non-profit, non-partisan research institution. Our mission is a simple one: to provide accurate and timely information on matters of federal, state, and local fiscal policy so that policymakers may make better policy.

Mr. Chairman, as an economist I am professionally compelled to make a prediction. And so I offer this prediction with more than the usual amount of confidence:

Five years from now, after Congress enacts and the President signs Social Security reform, after the kinks have been worked out and the

dicted to run dry in a time frame which actuarially speaking is rather soon. The pending exhaustion of the Trust Fund is both bad news and good news. It is bad news because of its implications for fiscal policy; it is good news because it forces action.

However, once we look at reform and see its consequences for the soundness and security of our national pension system and for the future tax burden on America's workers, we must truly ask ourselves why it took so long to consider these reforms. Even if Social Security was sound for as far as the actuaries could calculate, personalization would still be the best way to go.

True Social Security reform centers on the idea of individuals investing some portion of their payroll taxes in the private market. For many Americans, this is a novel idea. For diehard defenders of the status quo, the proposition is anathema. For millions of people in many countries, it is already working. As is now well known, Chile personalized its public pension system 18 years ago. Since then, Argentina, Colombia, Uruguay, Bolivia, Mexico, and El Salvador have followed suit in Latin America alone.

As John Goodman, President of the National Center for Policy Analysis has pointed out, "If the current trend continues, every country south of the border — with the possible exception of Cuba — will have privatized their pension programs long before Congress can agree on how to save our own."

I think John is too pessimistic. I believe the Congress and the President, working together, can get this done in the near future. Nevertheless, it is curious that the leader of the free world, the light on the hill drawing

Five years from now, after Congress enacts and the President signs Social Security reform, after the kinks have been worked out and the American people have had a chance to see how it works, the question on everyone's mind will be, "What took us so long?"

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We are now finally debating Social Security reform in earnest with the justified expectation that reform will soon happen. We are at this point because, as is now widely recognized, the Social Security Trust Fund is pre-

nations to democracy, personal freedom, and the superiority of private markets, should lag so far behind in turning Americans' pensions back to Americans.

Reasons for Reform

The most common reason given for Social Security reform is that the Trust Funds are projected to run dry some time around the year 2030. In fact, the trouble will begin much sooner when payroll tax receipts begin to fall short of current benefit payments. At that time, either taxes will be raised or spending cut to prevent Social Security from driving the consolidated budget back into the deficit from which we have just recently escaped.

Of course, there are those who will tell you the Trust Fund won't be bankrupt. There are those who will tell you this is not a "crisis" and, indeed, it is a subjective matter whether to apply that term. There are those who will tell you all you need do to solve the problem is raise the payroll tax rate 2 or 4 or 6 percentage points and the problem goes away. They are correct, of course. Similarly, for that matter all we need do is cut back benefits 20 or 40 percent to match receipts.

While these are surely simple solutions and they would work, the ease with which they are offered should in no way be confused with the enormous political difficulties and implications that would ensue if we actually tried to follow them. If you believe that a big increase in the payroll tax would be acceptable, or if you believe that a big cut in benefits would be acceptable, then there really is no issue. If these "solutions" are not acceptable, then we should put away simplistic notions and get serious.

A second reason for reform, and one just as compelling, is that the pension aspect of Social Security yields retirees a terrible rate of return. Depending on one's wage history the estimates I have seen run from a minus 1 percent real return to a plus 2 percent return. When compared to long-term returns that we see in the private markets of 7 or 8 percent, this is simply unconscionable. Of course, there are no guarantees that these historical returns will persist into the future. But the historical evidence is strong enough, and the future bright enough, that the burden of proof should clearly fall on those who claim they will not.

I would like to suggest to you two additional reasons why Social Security reform is imperative. The first is that the Social Security payroll tax has crowded out the ability of many Americans to save for retirement in any other

way. Let me give you a simple example.

Consider a family, two adults and one child, with total wages and salary income of \$50,000. Suppose the family has no other income. Their payroll taxes will be about \$3,820, not counting the employer's share. Their federal income tax after the \$400 per child tax credit, and assuming they take the standard deduction, is about \$4,800. In addition, they pay state and local taxes. If they live in Virginia, their state income tax will be about \$1,800. Suppose their other cash taxes — sales, property, various government fees — total \$500 a year. After taxes, this family has about \$39,040 in disposable income. (Note that these are cash taxes and cash wages. The employer's share of the payroll taxes and the family's share of the corporate tax burden have not been included.)

Total Income	\$50,000
Payroll Taxes	\$ 3,820
Federal Income Tax	4,820
Virginia Income Tax	1,820
Other Taxes	500
Total Taxes	<u>\$10,960</u>
Disposable Income	<u>\$39,040</u>

Now let's see how the family might spend this money, which totals about \$3,250 a month, keeping in mind these figures are just suggestive. Housing costs, including utilities whether renting or owning, might be around \$700 monthly. The family is likely to have a car payment of around \$400. At \$15.00 per person per day, the family's food budget for the month would be \$1,350. Other household expenses, like clothes, gas for the car, an occasional dinner out with friends, books and toys for the child, etc. would be at least \$300 a month. Thus, total regular monthly expenses would be about \$2,950, leaving the family with about \$300 for other expenses and saving.

Monthly Income	\$3,250
Housing Costs	\$ 700
Car	400
Food	1,350
Other Household	300
Total Monthly expenses	<u>\$2,750</u>
Remaining Monthly Income	<u>\$ 500</u>

The family might like to save this amount. But first it must deal with the extraordinary items that seem to come up from time to time and yet every month, such as car insurance, life insurance, car repairs, the child's braces,

medical deductibles and co-payments, dental deductibles and co-payments, Christmas presents, and college expenses. In short, once the family pays its taxes and its regular bills, there is little left for saving.

Looking at all the tax costs the family faces, clearly the largest is the federal income tax burden at \$4,820. The second largest are the payroll taxes. The payroll taxes are particularly important because most of them are supposed to be funding the parents' retire-

is true — it takes money to make money.

President Clinton recognized this when he stated in support of his Universal Savings Accounts, which would be in addition to Social Security reform, "I want every American to have a savings account and have a part of this country's wealth."

Unfortunately, as things now stand, America's workers are unlikely to reap much of this new wealth. There are two reasons for this. The first is that they cannot save a great deal on their own because their saving potential is largely crowded out by taxes, particularly Social Security taxes as described above. Without saving, they have no financial claim on this future wealth. The second reason is that their Social Security contributions are not invested in the private sector, and so their Social Security contributions have no claim on this future wealth either.

Today's payroll tax receipts cover current benefits and the excess pays for other government spending or to buy back government debt. None of the payroll tax receipts collected today are invested in real assets to pay future benefits. Under real Social Security reform, initially two or three percentage points of the current 12.6 percent payroll tax would be directed into an account at a regulated financial service company such as a bank or brokerage house. These accounts are sometimes called "Personal Security Accounts," PSA's. Individuals would invest their PSA money in real assets like corporate equities, corporate bonds, government bonds, and money-market instruments. In effect, workers' payroll tax "contributions" would build a real pension as opposed to contributing to other government spending priorities.

By way of background, let me review just a few numbers, starting with \$787 billion and \$2.6 trillion. The Congressional Budget Office projects a total surplus over the next ten years of \$2.6 trillion. Of that, \$787 billion is in non-Social Security accounts, \$1.8 trillion is in Social Security receipts. In other words, on average over the ten-year period, the federal government will receive \$180 billion in payroll taxes a year over what is needed to pay benefits. Average employment over their period will be about 150 million persons. If the entire Social Security surplus is returned to the worker to invest in his or her PSA, the average worker would invest about \$1,200 a year, of about \$100 a month. Over a thirty-year working life, that would provide total savings of over \$117,000 at an average return of 8 percent assuming a 2 percent annual adminis-

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ment income through Social Security. In effect, the forced contributions of the payroll tax are crowding out the private saving the family might otherwise achieve. Since Social Security effectively precludes the family from saving adequately on its own, it is imperative that Social Security yield a good return, which it does not, and that it be assured, which it currently is not.

Possibly the most important reason for reforming Social Security is to ensure that America's workers get a bigger piece of America's bright future. While we have our problems, America's future is undeniably bright. Our companies are among the most competitive in the world. Our institutions are strong. Our economy is a veritable job machine that appears able to adjust to changes in world economic conditions fairly easily.

All these good omens mean that over the next 10, 20, 30, 40 years shareholders and bondholders will receive hundreds of billions of dollars in dividends, interest, and capital gains. Who are these lucky people? They are the people who have wealth — people who save or who have inherited the savings of their parents and grandparents. The wonderful thing is that anyone can get a piece of this action by saving and investing prudently. Unfortunately, if you don't save and you don't inherit a chunk of capital from Aunt Bessie's estate, you're left out of the money. In short, the wealthy will get this wealth. The old saw

tration cost. At a withdrawal rate of \$20,000, this modest PSA alone would fund almost 6 years of retirement income.

Average Excess Social Security Receipts	\$180 Billion
Average Work Force	150 Million
Annual PSA Investment	\$1,200
Total PSA Value at Retirement at 8%	\$141,000
Years of Retirement Funded at \$20,000/year Annual Withdrawal	10

Giving individuals ownership and control of more of their retirement income is frightening to some. Because many Americans save little or nothing at all, they are unaccustomed to the process of investing and so they are concerned about the safety of their investments and their own ability to invest prudently. Even workers who save through employer-provided pensions rely on the pension managers to make the relevant decisions.

Comprehensive Social Security reform would include a long list of safeguards to address these concerns. For example, PSA owners could not make premature withdrawals from their accounts. PSA owners would be required to diversify their investments. They would not be permitted, for example, to make investments in obviously high-risk and speculative instruments like derivatives and options, nor could they invest most of their PSA funds in any one company or industry. And the financial institutions that maintain the PSA accounts would be subject to strict regulation, similar to those on deposit taking banks today. The government may even set up a special agency to invest PSA savings held in individual accounts solely in government bonds for individuals who so desire.

For those concerned about the level of retirement benefits both current and promised, I suspect reform would leave the existing benefit structure unchanged. In effect, reform would change the source of the benefit from taxes on workers to real assets controlled by the retiree, but it would not change the level of benefits.

With these safeguards in place, suppose everyone with wage and salary income is saving and investing in the private sector through Private Security Accounts. What happens? Much of the hundreds of billions of dollars in interest, dividends, and capital gains that would otherwise have gone to the wealthy

would now go to the working men and women of America. Social Security reform would transfer some of the bounty of America's future from the wealthy to workers. Low- and middle-income workers would get a bigger piece of the action, a bigger piece of America's bright future. But this would not happen through confiscation of wealth and income through high tax rates. It would

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happen because, through saving and investing their payroll taxes, working Americans would own more of America and would have a legitimate claim on the economic gains in America's future.

We should have abandoned the current Social Security structure long ago. The current system condemns payroll taxpayers to an abysmally low rate of return on their investment, generally far below that paid even by Treasury bonds. And, because the payroll tax is so high, particularly when added to federal and state income taxes, workers have little extra income to save and invest more wisely.

As a pension system Social Security guarantees workers a minimum benefit, and then virtually condemns them to doing no better. Real reform would break this cycle. And the more fully reform returns payroll taxes to the workers to invest on their own behalf, the more completely the cycle would be broken. When Social Security is personalized, the American worker will see his wealth grow over time. He will see manifested in his own Personal Security Account the advance of his economic status and the dignity and security of owning wealth.



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