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**THE NEW PROGRESSIVISM: PERSONAL SOCIAL SECURITY ACCOUNTS FOR
WORKING PEOPLE**

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The New Progressivism: Personal Social Security Accounts for Working People

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A personal account option for Social Security is the most progressive idea on the national agenda today. For no other reform would do so much to help working people, African-Americans, Hispanics, women, and the lowest income workers.

The Wealth Gap

Progressives have expressed great concern in recent years over a growing “wealth gap” in America. The top half of income earners have been riding the long term capital market boom, through IRAs, 401(k)s, stock options, etc. But those among the lower half of income earners are missing out, as they do not have the funds to save for such investments. As a result, they have been falling farther and farther behind, and the distribution of wealth and income is becoming more unequal.

A personal Social Security investment account option gives lower income earners their chance to participate in the capital markets as well. With the bottom half of income earners accumulating substantial capital for the first time, wealth and income distributions would become far more equal. Indeed, calculations done years ago by Harvard Professor Martin Feldstein indicate that shifting completely to personal accounts would reduce the national concentration of wealth by 50%.

Better Benefits

Far more concretely, the personal accounts would produce far higher returns and benefits for lower income workers. In *A New Deal for Social Security* (Wash. DC: Cato Institute, 1998), Michael Tanner and I offer the example of a low income, two earner couple who each earn the equivalent of the minimum wage each year throughout their careers. Suppose they could save and invest in a personal account what they and their employers would otherwise pay into Social Security.

After accounting for the survivors and disability benefits of Social Security, assume that with their funds handled by a major investment firm along with the funds of many other workers, the couple earns a 4% real return on their retirement investments. This is just over half the average return earned in the stock market over the last 75 years, and a modest return on a mixed portfolio of stocks and bonds.

The couple would reach retirement with a trust fund of about \$375,000 in today’s dollars, after inflation. The couple could use this fund to buy an annuity paying about 2.5 times what Social Security promises, but cannot pay based on the government’s own projections.

At a 6% real return, which is still less than the average stock market return over the last 75 years, the couple would retire with a trust fund of almost \$700,000 in today’s dollars. That fund would finance an annuity paying them about 5 times what Social Security promises but cannot pay. Indeed, the fund would

pay more than what Social Security promises out of the continuing investment returns alone, while still allowing them to leave the fund of almost \$700,000 to their children.

Perverse Discrimination

Perversely, Social Security promises an even worse deal for African-Americans. Because of their lower life expectancies, they tend to live fewer years in retirement to collect benefits, resulting in even lower returns. A black male born today has a life expectancy of 64.8 years. But the Social Security retirement age for that worker in the future will be 67 years. That means probably the majority of black males will never even receive Social Security retirement benefits.

The Heritage Foundation took this into account in a groundbreaking study calculating promised Social Security returns for African-Americans. This study found that the promised Social Security return for a low income single black male aged 30 today is a negative 0.66%. This is like paying the bank for holding your money, rather than receiving interest.

For an average income 30 year old single black male, the promised return is negative 1.5%. A two-earner, low income, black couple, each age 30, with 2 kids would still only receive a return of 1%. For the same couple with average income, the return would be zero percent.

In sharp contrast, the real rate of return paid by stocks over the last 75 years has been about 7.5%. The real return on corporate bonds has been around 3%, or more. An investment portfolio with half of each would earn about 5.5%.

With the personal accounts, this negative effect on blacks can be avoided. African-American organizations like the NAACP can offer investment programs and annuities to their members that take into account their lower life expectancies. Retirees can also use only part of their funds to buy an annuity matching what Social Security would pay, and keep the rest in reserve to use as they choose, leaving any remaining funds at death to their children. Those who die before retirement can also leave their account funds to their families.

The Worst Is Yet to Come

Of course, the government's own projected long term financial crisis for Social Security means the program will be an even worse deal in the future than suggested by the discussion above. The government's own reports indicate that in order to pay all promised benefits to those entering the work force today, Social Security revenues will be sufficient to cover only about 50% to 70% of promised benefits. The program's benefits will consequently have to be cut by 30% to 50%, or taxes raised by roughly 50% to 100%, or some combination of these two, to close the financial gap. Any of these options would lower the effective rate of return paid by Social Security, making the program an even worse deal.

These results would be most harmful for lower income workers. For these workers can least afford to pay higher taxes, or to suffer reductions in the meager benefits Social Security promises them. To the extent workers can shift to personal accounts, however, all of this would be avoided.

Finally, through personal accounts the socialist dream of the nation's workers owning its business and industry would be effectively achieved. But as this ownership would be direct, rather than through the

government, the result would be more appropriately called worker capitalism. With minorities and other workers all owning a share of the nation's business and industry, they would more vigorously support open market policies that promote prosperity for everyone.

Workers in other countries around the world are, in fact, already earning increased benefits through such personal account options. Polls consistently show that a substantial majority of American workers believe that they would get increased benefits from such personal accounts as well. Self-appointed elitists who would deny them this choice are not benefiting, or truly representing, the working people of America.

Designing A Progressive Personal Account Option

The Commission should focus on designing a progressive personal account option that will make good on the possible benefits for working people. One of the most important issues in this regard is what happens to the Social Security benefits of workers who choose the accounts.

A portion of those benefits are to be replaced by benefits from the personal accounts. If the portion of the current system's benefits to be replaced in this way is too large, however, then worker gains from the accounts will be lost. But if the portion to be replaced is too small, long term Social Security finances will suffer.

The best answer is to reduce future benefits from the current system for those who choose the accounts equivalently to the proportion of lifetime Social Security taxes the worker paid into the account. About 10 percentage points of the current Social Security tax goes to pay retirement benefits. If a worker paid 2 percentage points into a personal account each year for his entire career, his future benefits from the current system would be reduced by 20%. If the worker paid 5 percentage points into the account every year, that benefit reduction would be 50%.

Because the returns on the personal account investments will be so much higher than what Social Security promises or can pay, the personal account benefits replacing these Social Security benefits will leave workers with much higher retirement benefits overall. This would be true for all workers, including low income workers.

A progressive feature could be added to the plan, with the government adding to the contributions of the lowest income workers with some sort of match. Below certain family income levels, the government could contribute to each worker's account perhaps an additional 50% of what the worker contributed from his or her Social Security taxes. This would result in an especially large increase overall in retirement benefits for low income workers, with a greater increase the larger the option is.

All of this must be backed up by a government guaranteed minimum benefit, promising workers with personal accounts that they would receive at least the same benefits overall as Social Security would pay. If the account at retirement is insufficient for some reason to at least cover the Social Security benefits it replaces, the government would make up the difference. Every country that has moved to personal accounts has a similar safety net guarantee.

Another key issue is the question of transition financing. This issue arises because Social Security operates primarily on a pay-as-you-go basis. The money paid into the system today is not saved to pay

for future benefits, but is mostly paid out immediately to finance current benefits. Future benefits are to be paid in the same way out of the future taxes of future workers.

So if workers are allowed to pay part of what they would otherwise pay into the current Social Security system into a personal investment account instead, the question is how will the government get the money to continue to pay promised Social Security benefits to today's retirees?

Everyone has long agreed that there would be no reduction of any sort in benefits for today's retirees. But the transition need not and should not be financed by reductions in future Social Security benefits either.

President Bush has already said that transition financing would start with the Social Security surplus. He has advocated using about \$1 trillion of the projected \$2.6 trillion in Social Security surpluses over the next ten years for investment in personal accounts for workers who choose that option. In fact, it would be highly desirable to use much more of the surplus for an account option for up to five percentage points of the Social Security tax.

But the Social Security surpluses will run out by 2016. So how could the transition be financed after that time?

Those who have long advocated a personal account option have said from the beginning that general revenues would be needed to finance the transition. A simple method of providing for such general revenues would be to issue bonds to the trust funds in return for any payroll tax funds paid to personal accounts.

Historically, the Federal government has taken any surplus in Social Security and spent it on other government programs, replacing these funds with government bonds in return to be held in the Social Security trust funds. Today the Federal government is taking the Social Security surplus and using it to pay down Federal debt, while still giving Social Security back government bonds for the trust funds.

Similarly, for any Social Security surplus used for personal accounts, the government should continue to give Social Security back government bonds in return for the trust funds. This means even while using some or all of the surpluses for personal accounts, the currently projected trust fund totals will remain intact, financing the program's benefits through 2038, just as today.

Over the long run, the personal accounts themselves would reduce Social Security's financing gap.

Indeed, this same arrangement could continue indefinitely after 2038, regardless of the method the government chooses to close the program's financing gap after that time. The government could provide bonds to the Social Security trust funds in return for any payroll tax revenues invested in the personal accounts. As a result, the personal accounts would not result in the reduction of any resources to pay Social Security benefits. General revenues would simply be committed to financing Social Security benefits to the extent any payroll taxes revenues were used for personal accounts.

Over the long run, the personal accounts themselves would reduce Social Security's financing gap. Workers would then be reaching retirement with personal accounts financing a substantial portion of their

benefits in place of the current Social Security system. Social Security's benefit obligations would consequently be reduced, reducing the program's deficits as well.

If Social Security benefits for workers choosing the personal accounts were reduced proportionally to the amount of Social Security taxes they shifted into their accounts over their careers, as suggested above, then Social Security's long-term deficit would be reduced proportionally to the size of the personal account option. For example, if workers are able to shift about 30% of their payroll taxes into personal accounts over their careers, and almost all workers do so, then the long term Social Security deficit would be reduced by about 30% due to the personal accounts alone.

With this bond financing system, general revenues would simply be used, along with any Social Security surpluses, to cover the transition until this long run steady state can be achieved..

Advocates of personal accounts should reject the demands of critics that they specify now where the precise amount of general revenues needed for the reform each year for the next 40 years will come from. It is enough to demonstrate that the required general revenue financing would be feasible, in other words that there would be sufficient general revenues to handle the resulting obligation without unmanageable burdens on overall government financing.

One source of general revenues to help finance the reform would be any continuing general budget surpluses. The bond financing described above would be a means of tapping such general budget surpluses for Social Security reform. That would be a highly desirable use of such surpluses, as it would more likely increase national savings and avoid unnecessary, wasteful and even counterproductive government spending.

Moreover, the personal accounts themselves would help to pump up general revenues. Martin Feldstein has emphasized that any new investment through the accounts would increase tax revenues through taxation at the business level of the new before tax returns generated by that investment. Over time, this would potentially produce quite substantial revenue increases. 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 to \$20 trillion.

The supposedly horrendous, intractable, unmanageable transition-financing problem has consequently been solved.

Modest restraints in general Federal spending over the years, highly desirable themselves, would also free substantial general revenues for the transition. A small part of the transition financing burden, mostly in the earlier years, can be financed simply by issuing new general Federal bonds. These bonds can then be paid off later by the net surpluses that would result once the transition is completed. Some top flight economists, such as Milton Friedman, have, in fact, advocated financing the entire transition with such bonds, *but that* is not necessary. In my view, more general economic benefits result from minimizing such bond financing.

This is how the personal accounts would be "paid for," through these sources of general revenue financing, apart from the shorter term Social Security surpluses. The Administration can produce a detailed analysis showing that these different general revenue sources would be sufficient to make the transition feasible.

A final key question is how much of the current 12.4% payroll tax workers will be able to contribute to the accounts. While prior discussion has focused on an option for 2 percentage points of the tax, the Commission should propose at least allowing workers to choose to contribute up to 5 percentage points, as many on the last Social Security Advisory Commission did. The bigger the option, the bigger the increase in benefits for working people, and the more contributed under the government match to the accounts of the lower income workers.

This would basically allow workers a personal account option for half of their Social Security retirement benefits. The transition would start by using more of the Social Security surplus than currently planned, and then utilizing the other transition financing mechanisms discussed above.

Conclusion

A personal account option designed in this way would be the most progressive reform adopted in decades. It would increase retirement benefits for working people, particularly lower income workers, African-Americans, Hispanics, women, and others. At the same time, it would reduce the long term financing gap in Social Security without raising Social Security taxes or cutting retirement benefits. All of this would be backed up by a continuing safety net guarantee.

Moreover, the reform would greatly expand personal ownership of capital, basically providing that all workers would own a share of the nation's business and industry. This would result in a more equal distribution of wealth and income. It would, indeed, introduce a new, golden age of worker capitalism.

Surely, all thinking, forward looking, liberal minded progressives can join in supporting such reform.