Fixing Social Security

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JUST the right mix of piecemeal reforms could enable Social Security to teeter along the edge of financial catastrophe all through the next century without ever quite going broke. Every two or three decades, Congress would need to cobble together a rescue package out of such elements as a later retirement age, lower benefits, a higher payroll tax, and investing some of the Social Security trust fund in the stock market for a higher average return over time.

The fundamental problem with this approach to reform is not that it necessitates a political soap opera every few decades—although it does—but rather that in focusing on how to reconcile future benefits and taxes, it ignores the ongoing problems inherent in the structure of Social Security. The primary problem is that because people know that Social Security is waiting for them, they save less. In turn, lower domestic saving means either depending on foreign inflows of capital, which leaves the U.S. economy exposed to the vicissitudes of international capital markets, or investing less, which reduces growth in the nation's standard of living over time.

Martin Feldstein, George F. Baker Professor of Economics at Harvard, and a former head of the Council of Economic Advisers under President Reagan, has been studying these unwanted consequences of Social Security for years. In 1974, he published a much-cited paper suggesting that the expectation of receiving a dollar of Social Security wealth reduces saving by 30 to 50 cents. Feldstein has now edited *Privatizing Social Security*,[†] a high-powered collection of essays by top experts in the field.

For Feldstein and the other authors in this volume, privatization of Social Security is a mechanism for increasing the dismally low U.S. savings rate. Social Security is primarily a

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pay-as-you-go system, where taxes collected from current workers are immediately funneled to retirees. Although some payroll tax money is now increasing the Social Security trust fund, even when withdrawals from the trust fund are at their peak (a couple of decades into the twenty-first century), payroll taxes in any given year will account for four-fifths of all benefits paid in that year. In contrast, a system of private individual accounts means saving now. Since most American households save so little—in 1995, half of America's households had less than $10,000 in financial savings—even putting a few thousand dollars a year into a retirement account would plausibly lead within a few years to a substantial rise in savings.

The great virtue of these essays is to get down and dirty with details of how a privatized system might work. After an overview by Feldstein, the first five chapters discuss retirement systems with a significant private element—for example, those of Chile, Argentina, the United Kingdom, Mexico, and Argentina. Three chapters then offer simulation estimates of how the transition to a somewhat private system might work in the United States while the last two chapters look at the likely investment choices and administrative costs of a privatized system. This book is not aimed at a mass audience. The essays were originally presented at a 1996 academic conference, and the authors presume an interested readership that wants to know the intimate details of institutions and calculations.

A FIRST question about private accounts is how to pay for them. Privatized retirement accounts involve two steps: Private savings accounts must be set up, and the benefits already promised to retirees must be paid. One option would be to raise payroll taxes by about 2 percentage points for a time but allow individuals to put the extra money in their private accounts. Another would be to let individuals divert some of their Social Security taxes to a private account and then pay for current retirees by enacting a nationwide retail sales tax of about 1 percent. Neither of these options sounds pleasant—reductions in disposable income never do—but the fundamental reason for the privatization of Social Security is to increase savings, which by definition will mean consuming less in the present, one way or another.

With private accounts in place, controversy arises over how much choice investors should have. More choice means a wider range of rates of return, and thus retirees who put aside the same amounts of money could end up with quite different

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standards of living in retirement. This will lead, in all likelihood, to political pressure for equalizing some of these outcomes. In Chile, for example, each company that manages private retirement accounts is allowed to manage only a single fund. Funds that perform well are required to subsidize those that perform poorly, and government regulations guarantee a minimum return on each fund. As a result, most Chilean retirement funds make similar safe investments, while trying to attract new customers with offers of toasters and sneakers.

A wider range of accounts also means charges for switching between accounts and sales calls to encourage such switching. A single government system like Social Security avoids these costs. The tradeoff here is whether to allow a wide range of investments, with higher expenses, more freedom, and perhaps more need for detailed government regulations on the acceptable levels of risk, or to limit individual retirement accounts to large indexed mutual funds, like those run by Vanguard, Fidelity and others, with less choice and lower expenses.

As the money piles up in individual accounts, there will be pressure to allow people to tap those funds for causes other than retirement: education, house down-payments, medical care, child support or alimony, legal judgments, and so on. In Mexico, those with 150 weeks of payments into a retirement account are allowed to make a one-time withdrawal equal to their monthly wage when they marry!

Upon retirement, rules will be needed to specify how much can be withdrawn as a person ages and whether people must purchase an annuity to assure a stream of income throughout the rest of their lives. Other countries often seem to allow a phased set of withdrawals, depending on age and how much remains in the account.

A final set of issues is whether to attempt complete privatization or a "side-by-side" approach in which anyone who wants to stay in Social Security, as it is presently constructed, can do so, and anyone who wants the private option can do so. The United Kingdom carried out a side-by-side reform in the mid 1980s, in which the value of the basic state pensions was held constant in real terms, and people were given incentives to shift to a private system. As a result, Britain's private-sector pension funds are already larger than those for the rest of the European Union combined, and Britain's government—almost alone in the industrialized world—does not face any long-term fiscal crisis in paying for a greying population. Argentina also

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initiated side-by-side privatization; after just two years, 90 percent of new employees were choosing the private system.

THESE essays offer tough-minded support for a partial privatization of Social Security, at least. But, given the many issues that arise with private accounts, some may wonder whether the goal of greater savings might be achieved without privatizing. In theory, the government could raise taxes by the amount that would be in the private accounts, invest the money in whatever range of assets that would be allowed to private investors, and save up surpluses in the existing Social Security trust fund. Such a system could even make payments to individuals in line with what they contributed, as if everyone had invested in the same huge government mutual fund. This centralized system would have no sales costs and no administrative costs for switching accounts, and, since everyone would receive the same return, it would sidestep controversies over what investments should be allowed.

However, this vision of the federal government as the Godzilla of savings has a certain implausibility. It requires that the government hold literally trillions of dollars of surpluses in perpetuity without spending them or taxing them away. Surely, pressure would arise to use those trillions of dollars for some political purpose. More money for highways, anyone? Within a decade or two, the U.S. government could become the single largest shareholder in every large U.S. corporation. The temptation to micromanage corporate decisions and behavior could become irresistible. Although a socialism of savings works just fine in theory, in practice, it is likely to be considerably less optimal for both retirees and for the economy.

Social Security is popular—even beloved—and deservedly so. In 1970, lest we forget, 24.6 percent of all Americans over age 65 fell below the poverty line, compared with 12.6 percent of the population as a whole. By 1996, thanks to Social Security and Medicare, just 10.8 percent of those 65 and older were below the poverty line, compared with 13.7 percent of the general population. It is no criticism of this accomplishment to note that Social Security has promised far more in future benefits than it will collect in taxes. Something has to give. The only real question is whether we react with a grab-bag of medium-term solutions, or whether we really reform Social Security and improve America's low savings rate.

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