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REBUILDING SOCIAL SECURITY: PART 2 TOWARD LASTING REFORM

INTRODUCTION

Despite costly 1983 bailout legislation, the Social Security program remains plagued by the overwhelming problems described in Part I of this study. Not only do serious financing deficiencies threaten future benefits, but even if all the benefits promised to today's young workers are somehow paid, Social Security will still be a bad retirement deal for these workers. The program impedes economic growth, thanks to the payroll tax and its dampening effect on saving, and inflicts on retirees an inequitable, crazy-quilt benefit structure. Two workers paying the same taxes, for instance, can receive widely differing benefits. And the poor, blacks, and other minorities face severe discrimination in benefit levels.

These problems can no longer be ignored. They require fundamental reform based on the partial privatization of the system. This reform must begin by guaranteeing current retirees all their promised benefits--by providing a federally backed Social Security bond to each retiree. The next step would be to create a Super IRA for each worker. This would enable workers to take a 100 percent income tax credit for IRA contributions, in return for proportionate reductions in their future Social Security benefits. Workers would, of course, be free to forego this Super IRA option and remain in Social Security.

This reform would strengthen Social Security by easing the program's long-term financing problems. In addition, the Super IRA would provide today's young workers with higher retirement benefits than they are promised under Social Security. The reform could also massively increase national savings--generating more capital investments, job opportunities, and economic growth. And in contrast to Social Security's numerous inequities, the Super IRA would allow minorities and the poor at last to look forward to fair and secure retirement benefits.

THE STEPS TO REFORM

Four steps are needed to save the bankrupt Social Security system while providing a sound vehicle for retirement savings.

STEP 1

Guarantee the benefits of those already retired, and those about to retire, by providing retirees with a federal Social Security bond, specifying annual benefits and inflation adjustments.

The first element of any reform package must be an iron-clad guarantee that the elderly will continue to receive their promised Social Security benefits--in full.

The Supreme Court held in a 1960 decision, Flemming v. Nestor, that Congress can reduce or cut off Social Security benefits to any or all of the elderly at any time.[1] But this decision was based on the Court's interpretation of the statutory intent of Congress. Consequently, the decision can be reversed by statutory changes.

Congress, therefore, should enact a law granting each worker upon retirement a U.S. government bond stating a contractual entitlement to the Social Security benefits promised under the existing law. Current retirees would receive a similar bond. The bond would guarantee specific monthly benefits for the rest of the retiree's life, plus cost of living adjustment (COLA) increases, based on the law in effect when the person retired. Congress would still retain its authority to reduce the benefits to be received by new beneficiaries, and could thereby reduce the growth in benefit expenditures over time.

This would give Social Security the same legal status as any U.S. Treasury bond. The Constitution prohibits the federal government from reneging on its duty to pay interest and principal on such bonds.

STEP 2

Allow workers to contribute an amount equal to a maximum of 20 percent of their Old Age and Survivors Insurance (OASI) taxes to an IRA and take a tax credit equal to that amount (same for employer share) against income taxes. The worker's Social Security benefits would be reduced by the lifetime percentage contributed in this way.

The second element of the reform package would give workers the option of beginning to rely on Individual Retirement Accounts (IRAs) in place of part of their Social Security coverage. Starting on January 1, 1986, workers would be allowed to contribute to

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[1] 363 U.S. 610.

their IRAs each year, on top of any other sum they might contribute under current tax law, an amount up to 20 percent of their OASI taxes. Instead of the usual income tax deduction for these IRA contributions, however, workers would receive a full dollar-for-dollar income tax credit equal to the amount of such contributions. Workers would be allowed to direct their employers to contribute up to 20 percent of the employer share of the OASI tax to their IRAs, on top of any other contributions, with each employer also receiving a full income tax credit for these amounts.

Workers who utilized the credit option, however, would have their future Social Security benefits reduced proportionally. A worker who opted for the full credit during his entire working career, for instance, would have his Social Security benefits reduced by 20 percent. Workers could decline this tax credit option, of course, making tax-deductible IRA contributions under current law, without any reduction in their future Social Security benefits.

The tax credit option, in effect, would grant workers a rebate of part of their Social Security taxes--to the extent that they reduced their reliance on Social Security and increased their reliance on IRAs. But since the credit would be taken against income taxes--not payroll taxes--Social Security's revenue base would be left intact.

Since the proposal provides for a tax credit rather than a deduction, low-income and high-income workers would receive exactly the same tax advantage from the Super IRA option. Since the maximum tax credit proposed for employees is 20 percent of the employee share of the payroll tax (which is now leveled at 7 percent of wage income), virtually all employees would have sufficient income tax liability to offset against the credit. Insufficient income tax liability would, however, be a problem for some employers. Since the rationale behind the income tax credit is to grant a rebate of payroll taxes, however, the credit could be made refundable for the small proportion of cases where the firm's income tax liability would otherwise be insufficient.

STEP 3

Allow workers to contribute an amount equal to a maximum of 10 percent of their OASI taxes to an IRA for the purchase of term life insurance, and to take a tax credit equal to that amount (same for employer share) against income taxes. Workers with only one or no dependents could devote half or all of this additional contribution to retirement income. Survivors benefits would be reduced accordingly.

A third element of the reform package would begin January 1, 1990. Workers would be allowed to contribute additional amounts to their IRAs each year, up to a maximum of 10 percent of the employee's OASI taxes, to be used for the purchase of term life insurance. Workers could direct their employers to contribute up

to this amount to their IRAs for such purchases. Both employee and employer would receive an income tax credit equal to the amount of these contributions, instead of the usual IRA deduction.

An employee with no dependents would be allowed to devote these additional contributions to securing better retirement benefits. An employee with one dependent would be allowed to use half of these contributions for his retirement.

Social Security currently pays survivors benefits on behalf of a deceased taxpayer who leaves a wife and young children or an elderly spouse. For workers under 65, private term life insurance can entirely perform this function. Under Step 3 of the plan, a worker who died before 65 would have Social Security survivors benefits reduced to the extent he had used the tax credit option to purchase term life insurance in force when he died. A worker who had fully utilized the credit to purchase life insurance would have no survivors benefits paid on his behalf. For a worker who had used only half the credit to purchase such insurance, survivors benefits would be reduced by half.

Like the retirement credit, this additional life insurance credit option, in effect, would be a rebate of Social Security taxes for those who chose to rely more on IRAs and less on Social Security. But it would leave payroll taxes fully intact to pay Social Security benefits--without any need for general revenues. And just as in Step 2, the credit option would reduce Social Security expenditures to the extent it was utilized by workers willing to forego benefits.

STEP 4

Eventually allow workers to place an amount equal to all their Old Age, Survivors, Disability and Hospital Insurance (OASDHI) taxes into a "Super IRA," which would provide for retirement, survivors' benefits, disability, and medicare coverage.

The three steps already outlined would constitute an important initial Social Security reform package. But subsequent legislation could expand the private IRA option even further.

100 percent IRA Credit

The maximum credit for IRA contributions could be increased to 100 percent of OASI taxes, for both employees and employeers, in return for the worker accepting further Social Security benefit reductions.

Medicare and Disability IRA

Workers could be allowed to purchase disability and old-age health insurance through their IRAs in return for reduced reliance

on Social Security.[2] Ultimately, workers could rely entirely on IRAs for their retirement needs.

IMPACT OF THE REFORM PACKAGE ON SOCIAL SECURITY

Social Security Framework Strengthened

Such reforms would leave the Social Security framework in place, yet make it financially secure. Workers could choose to remain entirely in Social Security and receive the full benefits available under current law. But the Social Security structure would be expanded and strengthened by the reform package. Workers would be free to choose the best mix of public and private vehicles for their retirement needs. But they would continue to be required legally to choose some vehicle for retirement and insurance protection.

The reform would reduce Social Security expenditures over time, to the extent that IRA tax credit options were utilized and Social Security benefits foregone. Yet projected payroll tax revenues would remain the same, since the reform would do nothing to reduce such revenues. As a result, the reform would help close Social Security's long-term funding gap, strengthening the entire program.

Income Tax Revenue Effect of Step 2

The Treasury revenue loss due to these reforms would be relatively modest, especially considering the huge problems addressed. If the first income tax credit for IRA contributions discussed above (scheduled for 1986) were in effect in the current fiscal year (1984), and if all workers took full advantage of it, the income tax revenue loss would be $31 billion for this year.[3] But it is highly unlikely that all workers would utilize fully the credit option when first made available just as most workers do not have IRAs today. Assuming workers initially utilized the credit at double the rate they currently use conventional IRAs, the maximum revenue loss in the current fiscal year would be $12.5 billion.[4]

The tax credit option also would result in reductions in Social Security expenditures. Though these reductions would be

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2 A detailed proposal for allowing workers the option of substituting a "Health Bank IRA" for Medicare recently has been advanced in Peter J. Ferrara, John C. Goodman, Gerald Musgrave, and Richard Rahn, Solving the Problem of Medicare (Dallas, Texas: National Center for Policy Analysis, 1984).

3 Calculated from Social Security Board of Trustees, 1984 Annual Report of the Board of Trustees of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, D.C., April 5, 1984).

4 Ibid.

small at first, eventually they would offset the tax revenue losses entirely. In addition, the credit option would mean increased savings held in IRAs, which would mean more funds for the trustees of the accounts to invest in American industry--and added revenues to the Treasury from corporate taxation of the returns to this investment.

Implications for Government Borrowing

There should be $1 in new savings through IRAs for every $1 in lost revenues because the tax credit would only be allowed for long-term IRA savings.[5] So even if the federal deficit were increased temporarily by the amount of the net revenue loss, the U.S. pool of savings from which the deficit is financed would be increased. As such, there would be no net increase in government "crowding out" in the credit markets, because additional federal borrowing would be offset by new private savings.

Effects of Step 3

The second income tax credit of 10 percent, described in Step 3, would result in a revenue loss of $16 billion if it were in force in Fiscal Year 1984, and all workers fully utilized it.[6] But complete utilization of the credit in the first year would be unlikely. If utilized at double the rate of current IRA use, the revenue loss this year would amount to $6 billion.[7]

The Social Security expenditure reductions resulting from this credit would accrue far more rapidly than in the case of the 20 percent credit proposed in Step 2. There would be a reduction in the survivors benefits for dependents of workers who died, prior to the retirement age, in the first year of the credit--with private life insurance making up the difference. Once existing claims expired, benefit expenditures would decline to zero if all workers utilized the full credit and relied on private life insurance. In addition, increased business investment could be expected, since the amounts paid in life insurance premiums would be set

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5 To avoid the danger of a mere shifting of existing savings into IRAs to obtain the credit, workers should be prohibited from withdrawing before retirement IRA contributions, for which they obtained the credit, and the returns associated with those contributions. This would make the IRA savings unsuitable as a substitute for nonretirement savings since they could not be used for nonretirement purposes. Because Social Security benefits would be reduced for tax credited IRA contributions, the IRA savings would be needed to replace those lost benefits, and therefore would not be available as a substitute for other retirement savings either. As a result of these factors, any shifting of existing savings into IRAs rather than new savings to obtain the tax credit should be negligible, because such IRA savings would no longer be able to perform the function of other savings.

6 See footnote 3.

7 Ibid.

aside to finance the stream of benefits for workers' dependents. This would generate new tax revenues, which would offset the revenue loss due to the credit.

ADVANTAGES FOR BENEFICIARIES AND WORKERS

Young Workers

Young workers would receive full market returns on the money paid into IRAs. Consequently, they would be able to earn higher benefits than they could possibly receive for the same contributions to Social Security, as explained in Part I of this study.

If the complete Super IRA option were eventually phased in, most young workers could expect to receive between three and six times the retirement benefits promised under Social Security. Even low-income earners would receive about double the benefits promised to them by Social Security--and a couple with maximum taxable incomes could expect at least eight times the benefits.

The private IRA benefits, moreover, would be financed on a fully funded basis, which would secure them against the financing problems inherent in Social Security's current pay-as-you-go system. The IRAs would also allow workers greater freedom to choose their retirement age, since they would not lose benefits if they chose late retirement, as is the case with Social Security.

Reduction of Inequities Affecting Small Families

The proposed reforms would mitigate many of the inequities in the current Social Security benefit structure. Part I of this study noted that single workers without children and many two-earner couples must pay for Social Security survivors benefits even though such benefits will never be paid on their behalf; married workers without children are not eligible for survivors benefits until after retirement. The package would allow these workers, in effect, to use some of their Social Security tax money to purchase private term life insurance instead. And this insurance would pay full benefits to whomever the worker designated as his or her beneficiaries.

The reforms thus would increase greatly the flexibility of the retirement/insurance system, enabling workers to tailor coverage to their personal needs and preferences. In so doing, the package would eliminate one of the worst inequities in the current Social Security system.

A Better Deal for the Poor and Minorities

The poor and minorities especially would be helped by the proposed reform package. Though lower income workers tend to leave school and start work earlier than other workers, Social Security credits these workers with little if any additional

benefits for their early years of work and tax payments. With an IRA, on the other hand, these workers would receive greater benefits for early contributions, since the funds would have more years to accumulate interest before retirement. And Social Security pays additional benefits for married workers, yet single workers are much more likely to be poor. Married and single workers would receive the same returns with an IRA.

With a private IRA, moreover, a retired worker would be able to leave his entire, accumulated IRA fund to his dependents upon his death, whereas Social Security limits benefits to the much smaller survivors benefits. This aspect of an IRA would be particularly beneficial to the poor and to blacks and other minority groups with significantly lower than average life expectancies. The typical black male born today, for instance, can only expect to live to 64, and so would not receive a single day of full Social Security benefits. An IRA would enable him to leave his accumulated retirement savings to his family.

It should be noted that, under the proposed reform, the Supplemental Security Income program (SSI) would continue to provide means-tested, general revenue-financed welfare benefits to the elderly poor, thus ensuring that the income of retired Americans would not fall below a basic minimum. The better returns available from an IRA, however, would reduce the demands on this program.

Eliminating Risks to the Elderly

The proposed reform would carry no threat to the elderly--or anyone else--since promised Social Security benefits would be constitutionally guaranteed. But the capacity of Social Security to finance those benefits would be improved, since outlays would be reduced thanks to increased reliance on IRAs instead of Social Security.

Nor does the reform package pose any threat whatsoever to those workers who desire to remain exclusively within the Social Security system. Moreover, workers who chose the private IRAs would receive full credit, in the form of benefits, for the contributions they paid into Social Security.

IMPACT ON THE ECONOMY

The proposed reform package would boost the economy. National savings would be increased by the new IRAs. As the credit options became more familiar, virtually all workers could be expected to take full advantage of them. This could mean tens of billions of dollars in new savings each year, providing the capital for technological innovation, the creation of new jobs, and faster economic growth.

With a full option to rely on IRAs, private savings could be almost doubled, with potentially hundreds of billions of dollars in increased savings flowing into the capital markets each year. In a study prepared while he was at Harvard, Council of Economic Advisors Chairman Martin Feldstein estimated that such an increase

in savings would increase GNP by almost 20 percent.[8] And since the proposed reforms would reduce Social Security expenditures, job-killing payroll taxes eventually could be reduced.

Reduction in the Federal Role

The reforms would "denationalize" the large portion of the pension and insurance industry now represented by Social Security, shifting those functions to the private sector that can be performed by private firms. Transferring these functions would reduce government spending significantly. Complete reliance on private sector IRAs could mean more than a one-fourth reduction in federal spending.[9] Given that Social Security, Medicare, national defense, and debt interest account for almost three-fourths of the federal budget, it is hard to imagine a substantial reduction in the size and scope of government without such a reform.

CONCLUSION

Social Security remains in deep trouble with staggering financing problems and inequities that must be addressed. Now is the time to embark on fundamental, innovative reforms based on a true understanding of these problems, rather than wait for the next crisis and the accompanying hysteria. The most promising reform would allow workers gradually to substitute Super IRAs for Social Security. This would take nothing away from workers or retirees--it would merely allow workers greater freedom to choose how to provide for their retirement and income security. It is a reform of benefit to old and young, rich and poor, and both black and white Americans. Yet it would solve the enormous problems currently plaguing Social Security.

The temporary revenue costs of the reform are minimal compared to its enormous benefits. With the elderly assured of their benefits, Social Security strengthened, and today's workers merely allowed increased freedom and control, there is no reason why the reform should be anything but merely popular. It should, in fact, be considered a "populist" proposal.

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8 Martin Feldstein, "Social Insurance," Harvard Institute of Economic Research, Discussion Paper No. 477, May 1976, p. 33.

9 As noted in Part I of this study, Social Security, including Medicare, today accounts for almost 30 percent of the entire federal budget. With the insurance function of Social Security performed in the private sector, most of this spending would be taken out of the federal budget altogether and shifted to the private sector.

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