Personal Savings Accounts Would Be Good For Everyday Workers
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How would we fare if each of us had, instead of Social Security, a personal retirement account? I'll eliminate the suspense: Almost all Americans would make out much better with a privatized plan than with the government program.

To see why, you must compare a privatized retirement system with the way our current system works. When I pay taxes to the current system, there is no account labeled "David R. Henderson, Account No. 1234567," in which those payments sit and accrue interest. Rather, my taxes are mixed in with everyone else's, sit there a few weeks or months, and then are distributed to current Social Security recipients in monthly benefits. Similarly, when I retire, say, in 2016, I don't start drawing on my personal "contributions," the euphemistic term that the government has given to Social Security taxes. Instead, I collect money paid as taxes by people working in the year 2016.

That is why the current government-run system gives such a lousy rate of return to current recipients. Sure, it looked like a great deal to the original recipients. They made a killing because they had paid into the system for only a few years, but received substantial benefits for many years. Miss Ida Mae Fuller, for example, the first recipient of Social Security, received, by the time of her death, $20,000 in benefits in return for $22 in taxes paid. But in a mature system where participants pay taxes over their full working lifetime, there is no windfall. Compared to what they're putting into it, Social Security benefits for Baby Boomers and Generation Xers will be a losing prospect.

By contrast, the retirement income stream from personal retirement accounts would be much higher, even assuming moderate rates of return, and even if the amounts invested are much smaller than what Social Security is now taking out of our paychecks. And it would all be under your own control. This is what excites many of us who are chomping at the bit to make our own decisions, especially since millions of us are already doing so with our 401(k), 403(b), and Individual Retirement Accounts. Of course, this autonomy is also what scares some people (like President Clinton, as we'll see below), who doubt the ability of

Americans to make their own decisions.

What's in the Personal Retirement Account for You?

One way to assess personal retirement accounts is to compare the rate of return you'll get from your Social Security taxes with the rate of return you could earn by investing those same funds yourself. A 1987 study by Boston University economist Laurence Kotlikoff and Stanford economists Michael Boskin, Douglas Puffert, and John Shoven calculated real rates of return from Social Security. The results varied according to age, income level, and marital status, but the very best return earned by any sub-group was 6.3 percent a year. Most people got paybacks much lower than that, and for younger workers the returns will actually be negative.

These returns compare unfavorably to what you could earn with a simple portfolio of stock investments. According to Ibbotson Associates, a Chicago-based firm that computes stock market returns, the average rate of return on stocks between 1926 to 1995 (a period that includes the stock market collapse of the Great Depression) was 7.2 percent after inflation. Not one 30-year period has ever had a real rate of return below 6 percent. Private investment in stocks is vastly superior to Social Security in its ability to produce paybacks for workers.

Another, even starker, way of comparing Social Security to private saving alternatives is to look at the effect that Social Security taxes and benefits will have on your total wealth at the end of your life. Economists do this by first computing the value of all the Social Security taxes you will pay in your life, plus all the interest you would have earned if you'd been allowed to keep that money. Then they calculate the value of Social Security's benefits to you at retirement. The difference is Social Security's net effect on your wealth.

Doing just such a computation using moderate economic assumptions—a 6 percent rate of interest—Eugene Steuerle, an economist at the Urban Institute, found that someone born in 1955 who is married and making $60,000 in 1993 dollars as the sole provider will receive $750,000 less from Social Security than he or she paid in. An earner making $24,444 in 1993 dollars loses $268,000. A couple where both spouses work, with one earning $60,000 and the other making $24,444, lose over $1.2 million. That's right. It's as if the government took over $1 million from that couple at retirement. Think of Social Security as a negative lottery in which you are forced to participate and your odds of winning are virtually nil.

One of my students, Shawn Duffy, and I recently found that someone who worked for the minimum wage his entire life and then retired in 1994—supposedly just the kind of "little guy" Social Security was set up to bolster—would actually have done better without Social Security. Assuming he earned only 5 percent a year on money invested instead of being sent to Washington, this minimum wage worker would have been over $34,000 better off without Social Security. If he earned seven percent a year (the stock market average), he would have been over $100,000 better off without Social Security.

Because it is potentially a huge creator of new wealth (and not just a shell game that takes money from one person and gives to another), Social Security privatization has the potential to turn large losses into large gains for nearly all workers.

Not only that, but a personal savings system also promises to be more economically just. Incredibly arbitrary redistributions of wealth take place under our current Social Security system. (Actually, since the term "redistribution" implies that someone gains, while under Social Security almost everyone now loses, it might be more accurate for me to say that today's system causes some to lose a lot more than others.)

Black men, for instance, get a raw deal, because their life expectancy is comparatively low. A black male born in 1950, for example, had a life expectancy of 60.1 years. Since Social Security's retirement benefits don't kick in until after that, and cannot be willed to one's heirs, that means the average black male baby born that year faced a lifetime of Social Security taxes without offsetting benefits.

Some other groups and individuals face the opposite circumstance. They enjoy unearned windfalls. With personal retirement accounts, all these arbitrary impositions of wealth losses and wealth windfalls would be gone.

Are Americans Smart Enough to Manage Their Own Money?

Of course some people doubt that American workers are competent enough to plan their own futures and oversee their own money. In a September 11 interview with Money, President Clinton said of Social Security: "The people who read Money magazine probably would be much better off if it were partially privatized because they're intelligent, they're upscale, they understand investments. But the thing that's made [Social Security] work all these years is the fact that older people who had no education and wouldn't know how to make an investment were still going to have their income and return protected. I wouldn't feel comfortable supporting [privatization] based on the evidence I have now."

This statement leaves me thinking of how crabs in a trap behave: When one tries to get out, the others pull him back in. The President admits that Americans can do much better with personal savings accounts, but chooses Social Security's dismalness because at least then everyone will be doing equally poorly.

The fact is, every Social Security privatization proposal retains some safety net features that would catch the elderly who reach the end of their lives indigent, for whatever reason. So keeping the whole $300 billion program just to aid the 5 percent of senior citizens who are poor makes little sense. In addition, a system of personal savings accounts would allow older Americans who found they lacked enough income to retire in the style they wanted to keep earning money on the job. If you do that under Social Security, the so-called earnings penalty will reduce your Social Security benefit.

But what about Clinton's fundamental point: Is he right that many people would end up worse off thanks to bad investment decisions? We know that the members of the public who have the most to lose on this question don't agree with the President: Polling by Luntz Research shows that fully 82 percent of all 18- to 34-year-olds think they can achieve higher returns investing their retirement funds for themselves than the government can produce on their behalf through Social Security. And there's evidence they are right. A person would have to make exceptionally bad choices to do worse for himself than the government already does.

Consider some data from Stephen J. Entin of the Institute for Research on the

Economics of Taxation. Under a continuation of our present payroll-tax system, an average-wage worker who retires on schedule will receive annual Social Security benefits equal to only 29 percent of his pre-retirement salary. That same worker could beat his Social Security payout by investing just 3 percent of his wages annually in an everyday mutual fund that earned only historically average returns on a 50/50 balance of bonds and stocks. His annual retirement income would be more than twice what Social Security offered if he invested just 6 percent of his wages in this common, easy, low-risk fashion. (See nearby table.)

The bottom line is that you'd have to be even dumber than President Clinton thinks you are before you'd fail to beat Social Security's payoff. As twentysomething research assistant Julie Bassett puts it, "It shouldn't be difficult for younger generations to achieve higher investment returns on their own retirement investments considering that rates of return under Social Security are substantially below the rate of return to private capital investment and, in some cases, even negative. Educated or not, anyone knows that is not a good investment."

Navigating From Old to New

The main challenge in privatizing Social Security will be making the transition from our current system to the new one. Taking all the Social Security taxes currently being paid by you and your employer and investing them instead in your personal retirement account will leave a hole in the federal budget. A gaping $300 billion in annual benefits promised to current recipients must be paid for by someone. These government obligations to current beneficiaries already exist, of course; they are not a new cost. The question is simply how they should be financed.

Social Security reform can provide current recipients with all that they've been promised, while offering younger Americans something much better than the dismal arrangement the government currently imposes. The critical requirement for making a transition that imposes no big losses is privatization. If done carefully, privatization can actually help almost everyone and hurt almost no one. That's because funds the government now takes from people and spends immediately would instead be invested, where they would earn a healthy return.

If the political authorities settle merely for tinkering with the benefit formula or the retirement age, or raising taxes, they will necessarily impose large losses on some groups. But privatization, by allowing people to create greater wealth for themselves than the government could give them, benefits everyone. New wealth is necessary if every group is to gain, or at least not lose.

A Pretty Good Transition

One way to make the transition would be to let everyone out of Social Security who wants out, but make them "pay" to do so. Everybody under a certain age could be allowed to leave the program immediately, with their payroll taxes being cut roughly in half (depending on how much they'd already paid into the system) as a result. They would be required to re-channel their freed-up funds into private savings instead. These dropouts would give up all claims to future Social Security benefits and all credit for past taxes paid. The Social Security system's revenues would decrease, but so would its liabilities and the number of recipients. Temporary shortfalls between revenues and benefit payments could be made up by selling government assets and, if necessary, tapping general revenues.

Such a transition is not ideal for young workers—who would still have to pay around half what they currently do in retirement taxes as the price of bridging the gap between our current regime and the reformed one. But they would still be left with five or six percent of their wages freed up to invest, and thanks to the power of compound interest that would make them dramatically better off by the time they retire.

If I had been advising Franklin Roosevelt in 1937, I would have said, "Franklin, don't do it." Unfortunately, in 1997 we're trying to plan our way out of the mess that is fdr's legacy. Compared to what his system has in store for them, personal retirement accounts will do miracles for Baby boomers and Generation Xers.