

Why Does the Government Patronize Us?

By Edward C. Prescott

Radicalism: The conservatism of tomorrow injected into the affairs of today.

— *Ambrose Bierce*, “The Devil’s Dictionary.”

OF ALL THE economic issues facing Washington these days, one looms larger and larger as more time passes without a solution — how to fund our Social Security obligations. We often hear that the main problem is our aging demographics or the political games that are played with Social Security funds. While these may be problematic issues, they are only symptomatic of the fundamental predicament: Government has made promises that it can’t keep.

Heretofore, the government’s solution has always been to make more promises: “Don’t worry. We’ll figure something out. You’ll get your Social Security payments. Trust us.” But to savvy citizens these are starting to sound like pie-crust promises: Easy to make and easy to break. Indeed, Social Security benefit payments are projected to exceed payroll tax revenue in the year 2018, with Social Security trust fund depletion to occur in 2042. I would hate to be a politician in office when that pie crust breaks.

The time is right to act, and we don’t need a special commission to analyze the problem and recommend solutions because we already had one, and it submitted its report three years ago next month — The President’s Commission to Strengthen Social Security. The trouble is that little has happened since. It’s time to dust off that report, sharpen our policy pencils and get to work on reforming our Social Security system before it’s too late.

The main contribution of that 2001 bipartisan com-

mission was to propose the establishment of a system of voluntary personal accounts, which would increase national savings as well as increase labor-force participation — more on that later. But this contribution is also the commission’s main flaw, for the proposal does not go far enough. We need to establish a system of mandatory savings accounts for retirement, not voluntary. Without mandatory savings accounts we will not solve the time-inconsistency problem of people undersaving and becoming a welfare burden on their families and on the taxpayers. That’s exactly where we are now.

Before I describe the benefits of such accounts, let’s begin by dismissing the notion that individual savings plans are somehow dangerous to U.S. citizens. Some politicians have vilified the idea of giving investment freedom to citizens, arguing that those citizens will be exposed to risks inherent in the market. But this is political scaremongering. U.S. citizens already utilize IRAs, 401(k)s, PCOs, Keoghs, SEPs and other investment options just fine, thank you. If some people are conservative investors or managing for the short term, they direct their funds accordingly; if others are more inclined to take risks or looking at the long run, they make appropriate decisions. Consumers already know how to invest their money — why does the government feel the need to patronize them when it comes to Social Security?

It would be one thing if the government’s Social Security system paid a decent return, but as the President’s Commission reported, for a single male worker born in 2000 with average earnings, the real annual return on his currently-scheduled contributions

to Social Security will be just 0.86%. And for a worker who earns the maximum amount taxed (then \$80,400), the real annual return is a negative 0.72%. A bank would have to offer a pretty fancy toaster to get depositors at those rates of return.

Further, about two dozen countries have reformed their state-run retirement programs, including Chile, Sweden, Australia, Peru, the U.K., Kazakhstan, China, Croatia and Poland. If citizens in these countries can handle individual savings accounts, especially citizens in countries without a history of financial freedom, then U.S. citizens should be equally adept. At a time when the rest of the world is dropping the vestiges of state control, the United States should be leading the way and not lagging behind.

An important benefit of individual savings accounts is that they are transparent, and transparency solves many problems. For example, naysayers may point to the pension funds of such cities as San Diego and Minneapolis, which are currently struggling with underfunded pension plans. But these are pensions where individuals have no control over their contributions and where politicians, with the aid of accountants, can hide inadequate funding for a long period. The beauty of individual savings accounts is that each person decides how his money will be invested and, with the advent of the Internet, he can then monitor those investments at any time and easily make changes to react to changing investment news. Individual savings accounts are transparency in practice.

The benefits of such reform extend beyond the individual retirement accounts of U.S. citizens (although that would be reason enough for reform) — they also accrue to the economy. As noted above, national savings will increase, as will participation in the labor force, both to the benefit of society. On the first point, more private assets means there will be more capital, which will have a positive impact on wages, which benefits the working people, especially the young. More capital also means that the economy will have more productive assets, which also contributes to more production.

Regarding labor supply, any system that taxes people when they are young and gives it back when they are old

will have a negative impact on labor supply. People will simply work less. Put another way: If people are in control of their own savings, and if their retirement is funded by savings rather than transfers, they will work more. And everyone is better off. These are the type of win-win situations that politicians and policy makers should be falling over themselves to accomplish.

And those policy makers need to get beyond the idea of creating only voluntary savings accounts. Voluntary accounts are not the full answer. There is nothing wrong with making a reasonable level of savings mandatory. Remember that our current Social Security system is mandatory, but as it stands it is a mandatory tax that perpetuates a welfare system. It doesn't have to be this way. We should separate retirement savings from a system of welfare, and the most efficient way to do that is to turn our mandatory transfer system into a mandatory savings system.

Some analysts have suggested that we can't move from a transfer system to a saving system because current retirees will be left in the lurch. Who will pay for them if workers' money is suddenly shifted to individual savings accounts? There will indeed be a period of time, likely no more than 10 years, when narrowly defined government debt relative to gross national income would increase before decreasing. But government debt is small relative to the present value of the Social Security promises that currently exist. Further, the sum of the value of government debt and the value of these promises will start declining immediately.

Under a reformed system there will always be some individuals who, owing to disabilities or other reasons that prevent them from working, will not have sufficient savings in their old age. The solution is to include a means-tested supplement to ensure that those citizens receive a required payment — just like they receive today. Nobody gets left behind under this new system, and most will move ahead. U.S. citizens deserve more than a minimum payment, and the U.S. economy deserves more than to have its savings, capital and labor weighed down by an increasingly costly tax-and-transfer system.

So how would such a reformed system work? Here's a proposal: Have three-quarters of employer and employee

Social Security contributions (currently 12.4% of wages, salaries and proprietors' income up to \$87,900) put into an individual savings account. This would be deferred income with taxes paid when people receive their retirement benefits. The other one-quarter of Social Security contributions would finance welfare and increase the labor supply, resulting in higher output and an increase in tax revenues.

Reforming Social Security into a system of mandatory individual savings accounts is not as radical as it sounds. The world is moving in this direction, and here in the U.S. our citizens have been dealing with individual accounts for many years through their employers — and some of these are mandatory. As Ambrose Bierce's definition of radicalism suggests, someday we will look back and wonder what all the fuss was about. ■

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(See related letter: "*Letters to the Editor: Rescue Social Security! We've Done It Before*" — WSJ Nov. 16, 2004)

(See related letter: "*Letters to the Editor: First, We're Overprotected, Then Shoved Out the Door*" — WSJ Nov. 18, 2004)