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Social Security Reform: A Cost-Benefit Analysis

In a recent report, humorist Andy Borowitz writes, “in an effort to confuse the insurgents, President Bush said the U.S. will begin airdropping copies of his Social Security plan over Iraq.”

Social Security is a complicated program, so attempting to reform it can easily get mired down in complexity. But it doesn't have to. Instead of speculating about future rates of economic growth and investment returns, we can use historical data to determine what would have happened had Social Security shifted to personal retirement accounts (PRAs) in the early 1980s.

In 1982 the U.S. had an opportunity to reform Social Security by shifting from the current pay-as-you-go system to private accounts. Instead, the decision was made to “solve” Social Security's financial problems by raising payroll taxes and cutting benefits.

Where would we be today had the U.S. followed the direction of Chile, permitting workers to divert a full 10 percent of their income from Social Security taxes into their own accounts beginning in 1982? The table shows the results for three income classes: low-wage, median-wage, and high-wage workers. Two types of accounts were created: one for stocks and the other for bonds. The stock fund consists of returns to the S&P 500 stock index. The bond fund consists of buying corporate bonds with yields determined by Moody's AAA corporate bond index.

Several practical adjustments were made to account for the cost of administering and managing the PRAs. These adjustments reduce the returns to the private accounts, particularly in the early years.

Workers' Assets in December 2004 from Private Retirement Accounts Started in 1982

| | <u>Stocks</u> | <u>Bonds</u> | <u>Cost to Govt.</u> | <u>Net Benefit per worker</u> | |
|---|---------------|--------------|----------------------|-------------------------------|--------------|
| | | | | <u>Stocks</u> | <u>Bonds</u> |
| Low-wage worker (1982=\$7,000;2004=\$13,000) | \$87,164 | \$63,931 | \$36,476 | \$50,688 | \$27,455 |
| Median-wage worker (1982=\$20,000;2004=\$44,000) | \$262,769 | \$188,402 | \$112,083 | \$150,686 | \$76,319 |
| High-wage worker (1982=\$27,000;2004=\$60,000) | \$354,738 | \$262,148 | \$151,312 | \$203,426 | \$110,836 |

The benefits from the PRAs are the assets in each worker's account. At the end of 2004 a low-wage worker would have had an account worth roughly \$64,000 to \$87,000 depending on the mix of bonds to stocks. A hypothetical median-income worker would have had an account worth between \$188,000 and \$263,000. A high-income worker would have had between \$262,000 and \$355,000 in his or her account.

Using the average median worker's account of \$226,000 and multiplying it by a workforce of 100 million workers produces a rough estimate for total benefits: \$22.6 trillion. This represents the gross cumulative increase in workers' assets from having shifted to PRAs in 1982.

The costs of switching to PRAs must be subtracted from the benefits. So that it can continue to pay Social Security beneficiaries, the federal government must replace the funds going into PRAs. One option is for government to borrow the money. Assuming government borrows all of this money, it must also pay interest on what it borrows.

The least expensive way for government to borrow is to issue three-month Treasury bills. To determine the costs associated with the shift to PRAs, we assume the federal government issues three-month T-bills to replace the funds going into PRAs and to pay interest on the additional debt.

The cumulative cost, including interest, for funding the account for a typical worker amounts to \$112,000. Multiplying this by a 100 million workforce provides a rough estimate of the costs to government from funding the accounts—roughly \$11 trillion. Subtracting costs from benefits produces a figure of more than \$10 trillion for cumulative net benefits over the 22 years.

The figure for net benefits after only 22 years is reasonably close to some estimates of Social Security's current unfunded liabilities. This analysis suggests that the net benefits from creating PRAs are so great that this reform would make it unnecessary for policymakers to reduce Social Security benefits in the future.

Actually, the numbers used here underestimate the true net benefit that accrues to workers. Net additions to assets from the PRAs would have produced additional advances in productivity. These would have raised both workers' incomes and profits from what actually occurred. This, in turn, would have produced higher investment returns than those actually realized.

There is also another benefit to private accounts. Dramatic changes in behavior occur when individuals own an asset personally, as they do with PRAs. Under the current Social Security system, workers collectively own nothing more than a political promise that they will receive some future income. History shows there are dramatic differences in behavior and performance when individuals own property privately versus collective ownership.

Opponents argue that a transition to PRAs will cost trillions of dollars and saddle future generations with mountains of additional debt. They're correct. What they fail to realize is that the benefits of such a transition will produce trillions of dollars in assets that far outweigh the costs. The more aggressive the transition, the greater the additional debt ... and the greater the net benefits to future workers.

The failure to shift to PRAs in 1982 was a mistake that has cost today's typical worker more than \$100,000 in assets after allowing for all the costs associated with establishing the accounts. It is too late to correct a \$10 trillion mistake made more than two decades ago. Given that incomes and productivity are much greater today than they were decades ago, the future benefits from directing Social Security funds into private accounts should be even greater than that suggested by past experience.

Let's hope we don't repeat the \$10 trillion mistake made in 1982.