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Answering the Top 10 Myths About Social Security Reform

David C. John

In an effort to reform America's flawed Social Security system—which is destined for insolvency as the ranks of the baby boomers reach retirement age and even today produces only minimal (if not negative) returns—proposals have been offered to give workers an option to invest a portion of their Social Security taxes in personal retirement accounts (PRAs). Such proposals have met with a flurry of opposition, based on arguments that are incorrect and misleading. For example, some of these arguments include the claim that personal retirement accounts will entail a high risk of loss; the assumptions that the current system is risk-free and can remain solvent; or a failure to acknowledge that low-income, minority workers receive unacceptably low returns for their payments in today's system.

As the debate continues to heat up, these misconceptions have spread and often have taken on a life of their own, regardless of the absence of any basis in fact. These myths make it hard for workers to make informed decisions on their retirement finances that will affect not only their own well-being, but also that of their children and grandchildren.

These misconceptions and myths appear to have validity because they sound logical or contain phrases that mean one thing in the context of Social Security and something very different outside of it. Many of them began because workers lacked sufficient information about the way Social Security actually operates and about the nature of the personal retirement accounts that have been proposed to reform the system. Some of the myths were purposefully initiated more to promote a political agenda than to advance debate in pursuit of workable reform.

America's workers deserve a more informative, less partisan debate on Social Security reform than they are getting. While the current system may be able to pay for all the benefits that it has promised today's older workers and those who have already retired, it cannot do so for younger workers.

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There are only three ways to avoid an impending crisis of Social Security: (1) raise taxes, (2) reduce benefits promised to younger workers, or (3) make payroll taxes work harder and bring greater returns by allowing workers to invest all or a part of them in stocks or bonds through personal retirement accounts. While the first two options would make Social Security returns even lower than they are today, the third has the potential not only to address the impending insolvency of the system, but also to improve retirement incomes and help to close the gap between the payments promised by the system and the amounts that it is able to pay. Put simply, investments in stocks and bonds through personal retirement accounts can give workers a much higher rate of return than the current form of Social Security can offer.

The debate regarding Social Security reform is not an academic exercise, nor should it be used as a political ploy. The results of this debate will determine whether or not younger workers and their children will be able to receive retirement benefits that are comparable to those enjoyed by their parents.

The various myths and scare tactics that have emerged in the course of the debate do not alter the unpleasant realities that will confront American workers if substantial reform in the system is not implemented. It is time to debunk and put aside the myths that have buttressed the arguments against reform and created stumbling blocks in a quest for authentic, effective, and critically needed changes in the Social Security system.

—David C. John is a Research Fellow at The Heritage Foundation.

NOTE: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

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ANSWERING THE TOP 10 MYTHS ABOUT SOCIAL SECURITY REFORM

DAVID C. JOHN

The arguments against Social Security reform have rested on a great deal of incorrect and misleading information. As the debate continues to heat up, these misconceptions have spread and often have taken on a life of their own, regardless of the absence of any factual foundation. These myths make it hard for workers to make informed decisions on their retirement finances that will affect not only their own well-being, but also that of their children and grandchildren.

These myths appear to have validity because they sound logical or contain phrases that mean one thing in the context of Social Security and something very different outside of it. Many of them began because workers lacked sufficient information about the way Social Security actually operates and about the nature of the personal retirement accounts (PRAs) that have been proposed to reform the system. Some of the myths were purposefully initiated more to promote a political agenda than to advance debate in pursuit of workable reform.

A review of the common misconceptions about Social Security reform and the personal retirement accounts that have been included in proposals for reform will go far to promote a meaningful and productive debate.

MYTH #1: Introducing Social Security personal retirement accounts will result in reduced benefits for existing retirees and those close to retirement.

Arguments against personal retirement accounts hold that there will not be enough money to pay the full benefits promised to existing retirees and those close to retirement because the money that goes into personal retirement accounts will not be available to cover these costs. Critics further claim that, as time goes on and Social Security's obligations increase with the retirement of millions of baby boomers, benefits will have to be cut even further.

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FACT: For now, Social Security is collecting more than enough money both to pay full benefits to those who have retired or are about to retire and to allow for the establishment of personal retirement accounts.

In addition, as time goes on, the extra money needed for these accounts can be made available through the same method that is used today to finance Social Security.

Establishing personal retirement accounts would not require benefit reductions for either current retirees or those close to retirement. Depending on the reform plan adopted, it would not even require that any future retirees receive less than they are currently promised. The argument against personal retirement accounts assumes that Social Security is a closed system with money coming only from Social Security taxes. This is not true today and will not be the case in the future.

The Old-Age and Survivors Insurance (OASI) trust fund pays retirement and survivors benefits. In calendar year 2001, the OASI trust fund had a total income of $518.1 billion. Of that total, $441.5 billion (85.2 percent) came from payroll taxes, $11.9 billion (2.3 percent) came from income taxes paid on higher income retirees' Social Security benefits, and $64.7 billion (12.5 percent) was interest paid on special issue Treasury bonds contained in the trust fund. Both the income tax and the interest payments that the OASI trust fund received in 2001 came from *general* (non–Social Security) tax revenues such as federal personal and corporate income taxes and federal excise taxes.

During 2001, the trust fund paid out $375.6 billion in benefits (72.5 percent of the taxes it collected) and $2.0 billion (0.4 percent of all the taxes collected) for administrative expenses. The remaining $140.6 billion (27 percent of tax income) was retained in the trust fund.

The only questions to be answered are when Social Security will require additional general revenues and in what amounts. Under the current system, without PRAs, Social Security will begin to require large amounts of additional general revenues in 2017, when the system begins to pay out more in benefits than it takes in each year in taxes. The program will require about $6 trillion (in 2002 dollars, without including inflation) in general revenue between 2017 and 2041 to repay the trust fund. After that, current law does not allow Social Security to pay any more in benefits than it takes in annually in taxes. That would require that benefits be reduced by roughly 25 percent in 2041, with the total reduction going up to about 35 percent by 2077. If the law were to be changed to allow Social Security to pay full benefits, a future Congress would have to come up with an additional $19 trillion between 2041 and 2077 for a total of $25 trillion more in general revenue to make up for the shortfall from the amount that the system would receive in Social Security taxes.[1]

If personal retirement accounts are established, the money that goes into them will not be available for benefit payments. However, these accounts can be funded initially from the excess revenues that Social Security collects each year. Even after the Social Security surplus ends, taxes diverted to personal retirement accounts will not be lost, as the money in them will be available to help pay for younger workers' retirement benefits. This will reduce the amount of general revenues that Social Security will require in the future.

Once additional money is needed to pay benefits, the amount of general revenue that is designated for Social Security will have to be

1. Heritage Foundation Center for Data Analysis calculations based on numbers contained in Social Security Administration, 2002 *Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: U.S. Government Printing Office, 2002). The calculations used the same method that the Social Security Administration to create constant dollars.

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increased to make up the difference between tax income and benefits owed. No responsible reform bill would cause those benefits to be reduced, and neither Congress nor the President is likely to accept such a reduction.

MYTH #2: Unlike investment in the stock market, today's Social Security is guaranteed and risk-free.

This myth rests on the belief that there is no investment risk under today's system, since an individual's benefits are paid entirely out of taxes. Those who support this myth point out that Social Security is an entitlement that does not require congressional appropriations and that benefits are automatically paid out to anyone who meets the legal qualifications.

FACT: The current Social Security system is subject to the risk that future generations may not be willing to pay the continually rising costs of the promised benefits. The current Social Security system is not risk-free.

While there is no immediate investment risk associated with the program, its survival will depend on the willingness of future taxpayers to come up with the massive additional sums that Social Security will require. If Congress does nothing to reform the system, annual cash flow deficits are predicted to begin in 2017. In inflation-adjusted 2001 dollars, the annual deficits are estimated to reach about $72 billion in 2020, $275 billion in 2030, $429 billion in 2050, and $719 billion in 2070. It appears that the annual deficits would continue to grow in size for as long as the benefit payments and tax income can be projected.

The long-term projections of Social Security's financial health will continue to worsen because, with each passing year, a surplus year passes and a deficit year is added in the calculation. Over the period ending in 2077, Social Security's unfunded liability—the total amount that it will owe in benefits above the amount that it will receive in future taxes—will be about $25 trillion. The system's deficit will require massive additional sums of money, and paying benefits will require much higher taxes (Social Security taxes, income taxes, or other types of revenue), borrowing huge amounts of money, or sharp reductions in other federal programs.

Social Security taxes would have to climb by nearly 50 percent over the coming decades to pay future retirees their full promised benefits. If taxes were not raised, Social Security benefits would have to be reduced by as much as 35 percent by 2077. No matter which option Congress chooses, younger workers will receive far less for the taxes they pay into the system than they would from investments in personal retirement accounts.

No one doubts that future generations will want to pay future retirees the full amount of the retirement benefits that they have been promised. However, if Social Security is not reformed, the question of whether or not they will be willing to make the necessary sacrifices to do so remains. This puts future retirees' benefits at risk.

MYTH #3: The Social Security trust fund contains assets that make Social Security secure for the next 40 years.

Those who promote this myth argue that when the program's projected cash flow is combined with the amount of the bonds that will be in the trust fund, the system will have enough assets to pay full benefits through 2041.

FACT: The Social Security "trust fund" is, essentially, a system through which the government lends money to itself.

There is no pool of actual assets that is being reserved to pay the benefits of future retirees. According to the Social Security Administration (SSA), in just 15 years, the government will have to come up with new money just to repay the bonds that will be called from the trust fund. Between 2017 and 2041, it will have to make up for a total funding deficit of nearly $6 trillion.

The Social Security system has led most people to believe that their Social Security pay-

ments are being held in an actual account in their names to pay their benefits. In reality, however, the Social Security trust fund contains nothing more than IOUs that will be cashable only after higher taxes are imposed on future workers or massive amounts of money are borrowed. While many workers thought that the system's annual surpluses were being used to build up a reserve for baby boomers, in fact, this money has been spent to fund other government programs or to reduce the government debt.

In the private sector, trust funds are used to invest in real assets ranging from stocks and bonds to mortgages and other financial instruments. Assets are to be used only for specifically designated purposes, and the fund managers are held accountable if the money is mismanaged. Funds are managed in order to maximize earnings within a predetermined risk level. Investments are chosen that will provide cash at set intervals, allowing the trust fund to pay its obligations.

The Social Security trust funds are very different from those of the private sector. As described in a report from the federal Office of Management and Budget (OMB),

> The Federal budget meaning of the term "trust" differs significantly from the private sector usage…. [T]he Federal Government owns the assets and earnings of most Federal trust funds, and it can unilaterally raise or lower future trust fund collections and payments or change the purpose for which the collections are used.[2]

Furthermore, Social Security trust funds are "invested" exclusively in a special type of Treasury bond that can only be issued to and redeemed by the Social Security Administration. According to a report by the Congressional Research Service, "when the government issues a bond to one of its own accounts, it hasn't purchased anything or established a claim against another entity or person. It is simply creating a form of IOU from one of its accounts to another."[3]

According to the OMB, this situation allows funds to appear on the books while they are, in reality, unavailable:

> These [Trust Fund] balances are available to finance future benefit payments and other trust fund expenditures—but *only in a bookkeeping sense*. These funds are not set up to be pension funds, like the funds of private pension plans. *They do not consist of real economic assets* that can be drawn down in the future to fund benefits. Instead, *they are claims on the Treasury*, that, when redeemed, *will have to be financed by raising taxes*, borrowing from the public, or reducing benefits or other expenditures. The existence of large trust fund balances, therefore, does not, by itself, make it easier for the government to pay benefits.[4]

In short, the Social Security trust funds are really only an accounting mechanism. They show how much the government has borrowed from Social Security but do not provide any way to finance future benefits.

2. U.S. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2000* (Washington, D.C.: U.S. Government Printing Office, 1999), p. 335.
3. David Koitz, "Social Security Taxes: Where Do Surplus Taxes Go and How Are They Used?" Congressional Research Service, March 31, 1999, p. 3.
4. Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2000*, p. 337 (emphasis added).

MYTH #4: If Congress would stop spending the Social Security surplus and repay the money it has spent, there would be no need to fix Social Security.

This myth is based on the recognition that the federal government takes excess Social Security taxes and spends them to meet its bills and that, in return, the trust funds get only special issue bonds (IOUs) that will be repaid later. Those who promulgate this myth say that if Social Security's excess taxes were instead really invested, the program would have enough money to pay full benefits well past 2017.

FACT: Even if it were possible for the federal government to invest the Social Security trust funds, repaying the borrowed money would only delay—not solve—Social Security's financial problems.

Repaying the trust fund could delay Social Security's cash crunch, but it would not eliminate it. As described above, according to the Social Security Administration's own estimates, even with real money in the trust fund, the program will begin to run deficits in 2041 and will continue to run them as far into the future as the agency's forecasting tools can predict.

Social Security's calculations assume that the trust fund receives the same interest as other federal bonds. Even though the trust fund consists only of promises to repay the money, those bonds are still credited with the same interest rate that other bonds of the same maturity length issued on the same day would receive. Currently, the government does not have the ability either to save or to invest the money that is in the Social Security trust fund. Yet the 2041 deficit date assumes that Congress will somehow repay the $1.2 trillion that is currently owed to the trust fund and find a way to invest the additional surpluses as they occur.

If the government could invest Social Security money in stocks, the deficits predicted for 2041 could be avoided until a later time. However, allowing the government to invest the Social Security trust funds could create serious conflict of interest problems. For instance, if such investing had been allowed in the past, the U.S. government could have been the largest stockholder in Microsoft at the same time that it was suing the company for antitrust violations. It could also have been the largest stockholder in both WorldCom and Enron at the time of those firms' demise.

MYTH #5: Establishing a system of personal retirement accounts would drain between $1.0 trillion and $1.3 trillion out of the trust fund in the first 10 years alone, and the trust fund would be exhausted 14 years sooner than currently predicted.

Believers in this myth argue that the transition costs for establishing a system of personal retirement accounts would be huge and that the money that would go into those accounts would be unavailable to pay benefits to current retirees. They say that the surpluses in the system today are used to buy bonds for the trust fund and that, if this money were instead placed in personal retirement accounts, the trust fund would run out of money sooner.

FACT: In the long run, it would be more cost-effective to establish personal retirement accounts than to continue to fund the system as it is currently designed.

The exact amount needed to implement a system of personal retirement accounts in its first 10 years will depend on the specific plan that is adopted, but it is likely to be much less than opponents of the accounts claim. While implementing personal retirement accounts will involve transition costs, in the long term, the amount required to reform Social Security could be as little as one-third the cost of continuing the current flawed system.

Keeping the Social Security system solvent in the future will require additional money under any circumstances. The only questions are when additional funds will be needed and in what amounts. Practically speaking, the funds for moving to personal retirement accounts would come from the same source as the money that would be necessary to repay the Social Security trust fund. The two main

sources of such funds would be general (non–Social Security) revenues and loans in the form of government bonds. In fact, even the amounts needed to fund each option would be similar. The only issues that must be determined are the time at which payments should start and whether the trillions of dollars involved would in fact reform the system once and for all or simply delay its insolvency.

Under the current Social Security system, nearly $6 trillion (in 2002 dollars) would be needed just to repay the trust fund, with total cash flow deficits through 2077 running in excess of $25 trillion. In contrast, according to the Social Security Administration actuaries, it will take only about $7 trillion to fix the system permanently.[5] That number is the Social Security Administration's estimated transition cost both for Option 2 from the President's Commission to Strengthen Social Security[6] and for the DeMint–Armey reform plan.[7]

Under any circumstances, Social Security will require a great deal more money than it is receiving now if it is to remain solvent in the future. Although the exact amount that will be needed in the first 10 years will depend on the specific plan that is adopted, most experts estimate that the amount needed in the first 10 years will be closer to $500 billion than to the $1.0 trillion or $1.3 trillion figures that are often cited. Over the full 75-year period ending in 2077, if Congress delays a decision, it may have to come up with $25 trillion in total additional funding. If it acts quickly, these costs can be as low as $7 trillion.

MYTH #6: The Social Security system can be fixed by implementing modest changes, including raising the retirement age, making the wealthy pay taxes on all their income, or creating faster economic growth.

Those who spread this myth say that the program's average cash flow deficit (after repaying the trust funds) is 1.87 percent of taxable income—a relatively small gap that could be closed through modest changes in the current system rather than by instituting personal retirement accounts.

FACT: The current system will require a total of $25 trillion (in today's dollars without inflation) more in revenue than it will receive in taxes over the next 75 years, according to the Social Security Administration.[8]

It will require much more than modest changes to raise that amount of money. While modest changes may produce enough savings to reduce the deficit for a time, they cannot close it completely.

For example, one proposed modest step would be to raise Social Security taxes by about 2 percent of current tax income. This number was derived by calculating the mathematical average of the additional funds that the Social Security system will need over the next 75 years. The problem is that this approach does not allow for the fact that Social Security will not need the same amount each year. In the

5. See *Strengthening Social Security and Creating Personal Wealth for All Americans: The Final Report of the President's Commission to Strengthen Social Security*, December 21, 2001. The cost information is contained in the actuarial memo beginning as an appendix on page xv. The memo has its own page numbering, and cost data begin on page 32. These data are expressed both in terms of present-value dollars and as percent of taxable payroll. They were translated into a constant-dollar aggregate amount needed by the commission staff at the author's request.

6. The President's Commission to Strengthen Social Security was created in 2001 by executive order to study ways to preserve Social Security for at least the next 75 years. Both the commission's final report (*Strengthening Social Security and Creating Personal Wealth for All Americans: The Final Report of the President's Commission to Strengthen Social Security*, December 21, 2001) and its interim report, which details problems with the current Social Security system, are available at *http://www.commtostrengthensocsec.gov/reports/*.

7. The DeMint–Armey plan was introduced as H.R. 3535, the Social Security Ownership and Guarantee Act, on December 19, 2001. For more details, see *http://www.demint.house.gov/socialsecurity/index.htm*.

8. See footnote 1.

short run, the program will collect more money than it needs until 2017, but once annual deficits start, they will grow ever larger. Increasing Social Security's revenues by the same amount each year would provide much more money than it can use at first, and then, not nearly enough.

Raising Social Security taxes by 2 percent of income only delays the deficits for about six years; it does not end them. By 2050, the program would be running an annual deficit of $163 billion, which would rise to $365 billion a year by 2077.

Calculations by the Social Security Administration likewise show that faster economic growth would not be enough to fix the deficit problem. Even when a growth rate that far exceeds historic levels is presumed, the system would still begin to experience massive deficits within just a few years. Higher economic growth—and the resulting higher wages—would allow the program to receive more money in the short run, but it is also correlated with greater benefits for retirees.

Another modest approach to reform that has been suggested is to make higher-income workers pay Social Security taxes on their entire income rather than on just the first $84,900 they earn. Even this relatively substantial increase in the tax burden on targeted workers would only delay Social Security's annual deficits by approximately six years. Though more money would initially come into Social Security's coffers, the program would ultimately be responsible for paying greater benefits for retirees who had higher incomes. Although the government could opt to collect higher taxes from certain citizens without offering higher benefits, such a move would be the first step in transforming Social Security into a welfare program.

Moreover, such a tax increase would have serious consequences for the nation's economy. While those who support this tax increase may envision it as a tax on the rich, it would in fact affect millions of middle-income families as well. Combined with federal and state income taxes, it would raise their overall taxes to 50 percent or even 60 percent of income. Making matters worse, because such an increase in taxation would also affect entrepreneurs and business owners, it would result in job losses as businesses downsized to make up for the greater tax burden.

MYTH #7: Personal retirement accounts would result in high administrative costs that would eliminate any benefits the accounts would bring, and the only people who would be better off would be the wealthy and Wall Street.

Critics of personal retirement accounts who espouse this myth argue that most private-sector bank and brokerage accounts charge administrative fees that are higher than the amount that it costs to administer Social Security. They say that if private funds managers administer the assets of personal retirement accounts, their owners will have to pay high administrative fees.

FACT: It would not be difficult to develop a simple personal retirement account system that would have very low administrative costs.

State Street Trust, one of the largest managers of retirement savings, has produced a realistic estimate of the cost of a personal retirement account.[9] Using proprietary data the bank accumulated from its experience in managing a host of pension plans, State Street estimated an annual per-person administrative cost of $3.38 to $6.58. Expressed in terms of the percentage of assets under management, the annual fee would be only 0.19 percent to 0.35 percent. This fee assumes an annual contribution per worker equal to 2 percent of his or her gross earnings. The cost would drop significantly if that contribution climbs to an amount equal to 4 percent of earnings. State Street's findings

9. State Street Corporation, "Administrative Challenges Confronting Social Security Reform," Boston, March 22, 1999.

were reviewed and accepted by the U.S. General Accounting Office as accurate.

History shows that administrative costs are highest when a system is first implemented and start-up costs must be covered. As time goes on, administrative costs decline significantly. This is true in the case of 401(k) accounts, the Thrift Savings Plan (TSP) for federal employees, and even Social Security. Over the years, for example, the administrative costs of 401(k) plans have decreased despite the growth in investment options and the level of personal service. Although the costs of specific plans vary according to each plan's complexity and size and the type of assets in which the plan is invested, many large companies have been able to keep their annual costs as low as 0.3 percent by offering only a limited number of broad-based funds.

The federal Thrift Savings Plan, which is a privately managed retirement plan open only to federal employees, has experienced a dramatic 76 percent reduction in administrative costs since the system started in 1988. Participants pay administrative fees that are below 0.10 percent of assets under management annually. The TSP's very low administrative costs are significant, given that many experts expect that a system of personal retirement accounts would closely resemble the structure and investment choices found under this plan.

The Social Security system experienced similar reductions in administrative costs during its formative years. In 1940, when the system first began to pay benefits, its administrative costs equaled 74 percent of all Old-Age and Survivors Insurance benefits paid. In 1945, this figure had declined to 9.8 percent. Today, administrative costs make up only 0.64 percent of payments from the OASI trust fund. Even though this is not a perfect comparison with private-sector management, given that Social Security's structure has changed over the years, it does provide analysts with an idea of the potential cost reductions that may be possible.

MYTH #8: The recent decline in the stock market proves how dangerous personal retirement accounts would be. If the Social Security trust fund had been invested in stocks, it would have lost billions of dollars in the past three years.

Those who believe this myth point out that the stock market declined by approximately 12 percent during the second quarter of 2002 alone and say that if personal retirement accounts had been allowed and had been invested in stocks, they would have lost much of their value and would be unable to provide adequate Social Security benefits to retirees.

FACT: Because retirement investing takes place over decades and not just a few years, longer-term gains will more than make up for periods during which there are stock losses.

Studies that purport to show that the Social Security trust fund would have lost money over the past few years if it had been invested in stock focus only on the short-term market trends. They do not include any longer-term benefits that would have been gained in the past or are likely to be gained in the future. In addition, they assume that 100 percent of the trust fund would have been invested in stocks, rather than a diversified portfolio that would have balanced stock losses with gains on bonds or other investments.

Since 1802, stocks have earned an average of 7 percent annually, after adjusting for inflation. This average includes figures during the Great Depression and all recessions throughout the past 200 years. Even after recent losses in the market, a personal retirement account invested in stocks throughout the past 40 years would pay almost three times more in retirement benefits than today's Social Security does. Moreover, personal retirement accounts would be less sensitive to market changes than a portfolio that is composed solely of stocks because, as an individual nears retirement, investment portfolios tend to become more diversified with higher proportions of less volatile instruments.

RISK-LIMITING FEATURES FOR RETIREMENT INVESTMENTS

In practice, private-sector retirement investments incorporate risk-limiting features to reduce losses from market fluctuations. The features described below could also be incorporated in Social Security personal retirement accounts.

Different Portfolios for Older and Younger Investors

Today, investment advisors regularly structure retirement accounts so that as workers age, they shift more funds into fixed-income investments. Through this process, they tend to lock in earnings by decreasing the proportion of investment in stocks. A recent survey of 401(k) plans shows that, in comparisons with investors in their twenties, investors in their sixties invest less of their portfolios in equity funds (44 percent vs. 63 percent) and much more (23 percent vs. 8 percent) in guaranteed investment contracts and similar instruments that pay a fixed interest rate. Similar practices could also be applied with regard to Social Security personal retirement accounts.

This is significant for retirement investments since decreasing the proportion of investments in stocks reduces the potential for short-term loss. While younger investors may opt to invest most of their assets in stocks to get higher returns, those closer to retirement can reduce the risk of being affected by a sudden downward shift in the market. As a case in point, in spite of the market fluctuations during the second quarter of 2002, older workers whose money was invested 40 percent in stocks and 60 percent in tax-exempt bonds would have seen their assets decline by only approximately 2.9 percent.

Stock Index Funds vs. Individual Stocks

Stock index funds that track the entire market are much less volatile than individual stocks and funds that track only one economic sector. For example, on August 21, 2002, Standard & Poor's 500 index rose by 1.3 percent; on the same day, Pure Resources, Inc., stock increased by 34.2 percent while Radio Shack stock declined by 16.4 percent. While individual stocks may fluctuate dramatically from day to day and the earnings of individual companies that make up an index change frequently, the index that reflects the entire market remains much more stable.

Long-Term Investments in Stocks

Legislation creating personal retirement accounts could be designed to discourage short-term trading. Though stock returns fluctuate widely from year to year, historically, earnings on stocks held for 20 years or more have always gone up. This is significant for the case of personal retirement accounts because retirement assets are usually held for 20 to 40 years. In a study of market trends since 1926, the investment analysis firm Ibbottson & Associates found that large-company stocks have had returns that varied from +53 percent in 1954 to –43 percent in 1931; however, when those same stocks were held for 20 consecutive years, they had positive average annual returns despite economic downturns (including the Great Depression).[1] Holding stocks for even longer periods would produce even greater gains. Professor Jeremy Siegel of the Wharton School at the University of Pennsylvania found that, since 1871, stocks held for 30 years have *always* outperformed bonds and Treasury bills.[2]

Blended Portfolios

Funds managers should allow workers to invest retirement account funds in mixed portfolios of stocks and other investments. Such portfolios would ease concerns about market fluctuation, since some money would be invested in safer instruments. As the demand for retirement investment and annuity products grows, new instruments that combine reduced risk with higher returns are being developed. One securities firm has developed an inflation-indexed annuity with a survivor's benefit. Insurance companies are developing packages that include both investments and life insurance. Any of these products would be suitable for personal retirement accounts.

Series I Bonds or Similar Investments

Legislation creating personal retirement accounts could also allow workers who wish to avoid any risk to invest in U.S. Treasury I Bonds, which currently pay 2.0 percent plus inflation and have no administrative charges.

1. Ibbotson Associates, *Stocks, Bonds, Bills and Inflation 2000 Yearbook* (Chicago, Ill.: Ibbotson Associates, 2000), pp. 198 and 208.
2. Jeremy J. Siegel, *Stocks for the Long Run* (New York, N.Y.: McGraw-Hill, 1998), p. 28.

(See text box, "Risk-Limiting Features for Retirement Investments.")

Morningstar, Inc., an independent market data and analysis firm, estimates that the value of mutual funds invested in diversified U.S. stocks declined 12.1 percent during the second quarter of 2002. However, not all types of investments went down. Mutual funds containing the lower-risk instruments such as taxable bonds (which are routinely held by those nearing retirement) rose an average of 1.4 percent over that same period, while funds invested in tax-exempt bonds rose 3.2 percent. Series I U.S. Savings Bonds (I Bonds) also saw positive results and paid 2.57 percent annually (2.0 percent after inflation) through November 1. Thus, even with recent stock fluctuations, the long-term prospects for earnings in personal retirement accounts remain strong.

MYTH # 9: Introducing personal retirement accounts would reduce Social Security's disability benefits.

Currently, both Social Security's retirement program and its disability program use the same formula to calculate benefits. Those who say that personal retirement accounts would jeopardize disability benefits say that any reform that changes the current formula to adjust for retirement benefits from the accounts or to reduce costs would necessarily lower disability benefits. They say that PRAs would not have sufficient funds to make up for the lost benefits.

FACT: Personal retirement accounts could easily be designed to avoid any changes in disability benefits.

Those who believe this myth are correct in their claims that changing government-paid retirement benefit formulas *without retaining the existing formula for disability benefits* would reduce those payments and that a legislated change in annual cost of living adjustments would have the long-term effect of reducing disability benefits. However, although Social Security's retirement and disability programs currently use the same formula to calculate benefits, there is no reason why Congress could not continue to use the existing formula to calculate disability benefits while creating a new formula for retirement benefits. That would leave disability benefits unaffected by the change in retirement benefits.

MYTH #10: Lower-income and minority workers are better off with the current Social Security system. The rate of return is not a primary concern because Social Security is essentially an insurance program.

Proponents of this myth argue that the existing Social Security system pays proportionately higher benefits to lower-income workers than it does to higher-income workers and that minority workers likewise receive proportionately more from Social Security's disability program than non-minority workers. They stress that Social Security was intended to be an insurance program and say that, similar to holders of car insurance, Social Security enrollees should not feel cheated if they do not have to collect on their investment: It should be enough for them to know that funds would be available if they needed them.

FACT: Personal retirement accounts would allow lower-income and minority workers to earn more on their Social Security investments and could create assets that could be passed on to their families.

Although Social Security is structured to pay higher benefits to workers with lower incomes, low-income African–American males may actually pay more into the system than they will ever receive in benefits, even under the most favorable assumptions. To receive a favorable rate of return on Social Security payments, a worker has to live long enough to receive in benefits more than the amount that he or she paid in taxes. Statistics show that lower-income workers have a much shorter average lifespan than upper-income workers do. Therefore, although they receive higher benefits relative to their incomes, they receive them for a much shorter length of time.

Making matters worse, the current Social Security system does not allow these workers to create any sort of nest egg that could be left to their families in the event of an early death. Instead, today's system pays low benefits to limited categories of survivors. In contrast, a system of personal retirement accounts would allow workers to create wealth that could be left to their families or even to organizations such as their churches.

As a case in point, a single, low-income, African–American male born after 1959 would actually lose money under the current system of Social Security. On average, a single African–American male in his mid-20s who earns about $13,000 a year would receive only approximately 88 cents in retirement benefits for every dollar that he paid in Social Security taxes—a lifetime loss of about $13,400. Had such an individual been allowed to invest his Social Security retirement taxes in a portfolio comprised of 50 percent government bonds and 50 percent stock equity funds, he would have received $145,000 in returns on his investment at the time he retired.

On average, a 21-year-old African–American single mother who earns approximately $20,000 per year (the current average income for African–American females) can expect to receive a rate of return from Social Security of only 1.2 percent. If the amount that she and her employer paid in Social Security taxes had instead been invested in U.S. government bonds, she would receive a return of approximately 3 percent—$93,000 more than she would get from Social Security—for her retirement. Had the money she spent for Social Security taxes been invested in a portfolio comprised of 50 percent government bonds and 50 percent stock index funds, she would have earned nearly $383,000 (before taxes) for retirement—$192,000 more than she would get from Social Security.

Because of their lower life expectancy, African–Americans are hit especially hard by the inability to include their lifetime investments in the Social Security system in their estates. Except in situations where a worker leaves behind young children or a spouse who has lower benefits, the money invested by low-income minority employees will permanently leave their family and community at the time of their death and instead benefit others with longer life spans.

With regard to disability benefits, while it is true that African–Americans and other minority groups do receive proportionately greater benefits than non-minority workers, Social Security's disability program is a separate program that is financed by its own tax and has its own trust fund. The fact that minority workers do better under Social Security's disability program does not make up for the fact that they do much worse than non-minority workers under its larger retirement income program.

Moreover, Social Security should not be considered simply as an insurance program any more than workers would view their 401(k) plans as "insurance." Workers view Social Security as they would any other retirement plan and see it as a way to provide income after retirement. Therefore, the Social Security system should be measured against other alternatives with regard to its capacity to function as a cost-effective source of retirement income.

CONCLUSION

America's workers deserve a more informative, less partisan debate on Social Security reform than they are getting. While the current system may be able to pay for all the benefits that it has promised today's older workers and those who have already retired, it cannot do so for younger workers.

There are only three ways to avoid an impending crisis of Social Security: (1) raise taxes, (2) reduce benefits promised to younger workers, or (3) make payroll taxes work harder and bring greater returns by allowing workers to invest all or a part of them in stocks or bonds through personal retirement accounts. While the first two options would make Social Security returns even lower than they are today, the third has the potential not only to address the impending insolvency of the system, but also to improve retirement incomes and help to

close the gap between the payments promised by the system and the amounts that it is able to pay. Put simply, investments in stocks and bonds through personal retirement accounts can give workers a much higher rate of return than the current form of Social Security can offer.

The debate regarding Social Security reform is not an academic exercise, nor should it be used as a political ploy. The results of this debate will determine whether or not younger workers and their children will be able to receive retirement benefits that are comparable to those enjoyed by their parents.

The various myths and scare tactics that have emerged in the course of the debate do not alter the unpleasant realities that will confront American workers unless some type of reform in the system is implemented. It is time to debunk and put aside the myths that have been stumbling blocks in a quest for authentic, effective, and critically needed Social Security reform.

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