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How to Save Social Security
Meet the President's Goal of an Ownership Society
Simplify the Tax Code
Live up to the Promises of the Program
Provide for the Comfortable Retirement of Every Citizen
Pay for it all without Increasing Taxes
And Make it Acceptable to Almost Everyone

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Introduction

The social security debate is not really a debate at all, at least in terms of defining it as an argument based upon facts and reason. It is, in essence, simply a political issue, and the ultimate outcome will be defined more by political preference and scare tactics than by rational decision making. This paper is intended to present a rational choice.

Here are the simple facts. There is no Social Security Trust Fund. If there were, it would contain about $1.5 trillion, and this year it would grow in size by approximately $150 billion. In other words, more money is being collected from workers' pay (about $600 billion annually) than is currently being paid out to social security recipients (about $450 annually). That $150 billion surplus does not find its way into any protected account, but it is simply a revenue item in the federal budget. If this $150 billion wasn't collected from workers' pay, the federal deficit would be greater by the same amount.

If this sounds like a good business model, think again. From 2008 forward that $150 billion will decline by $15 billion annually, and in 2018 it will disappear completely. At that point social security recipients will begin to draw more money than will be collected from workers' pay. Moreover, this shortfall will grow every year indefinitely into the future.

Viewed in the best possible light, in 2018 this imaginary Social Security Trust Fund will contain about $2.5 trillion, and by 2042 it will be depleted and completely disappear. In terms of the federal budget, however, it is a growing problem every year from 2008 into the future. However, is it the huge problem proponents of privatization seem to be arguing?

Those who wish to maintain the current system argue that all we need to do is make some adjustments. Social Security taxes could be increased; the retirement age could be extended, and so forth. These arguments are essentially correct. We can save social security for our children and grandchildren simply by making some rather modest adjustments. If we choose not to make these adjustments, or don't make all that are necessary, it would seem likely that the U.S. Government would divert whatever amount would be needed to assure the viability of the Social Security system for many years to come.

The fact is, that with just a little determination and some minor adjustments, Social Security will be there for us, our children, and it will live up to all of its promises. If you like what you see in today's system, the political argument falls clearly on the side of those who want to maintain the system in its current form.

There is a much more basic issue, however. If Social Security were a private insurance business designed to provide for the retirement of its clients, it would be a colossal failure. It extracts 12.4% from all but the very privileged and delivers a service to recipients who, as a group, would never have chosen it from the start.

For some 40% of the population who depend on social security for most of their retirement income, the current system is clearly inadequate. It provides this group with an existence somewhere near the poverty line. For 30% of the population who have been in the fortunate position of having had sufficient income to provide separately for their retirement years, the current system is expensive, unnecessary and of little ultimate benefit. It even goes so far as to penalize them (loss of $1 for every $3 earned) if they choose to work and receive benefits before the mandated retirement age. Arguably, the middle 30% of the population might find social security to be a meaningful supplement in their retirement years.

As a safety net, the current system does its job. For those most in need it provides a welcomed service. So why not simply price it accordingly? If the system doesn't adequately provide for retirement, expensive as it is, why not simply do away with it in its current form and change it to a safety net model which best serves society?

Two reasons stand out. The first is that it would be inherently unfair to those who save for retirement rather than spend. Why save for retirement if the social security safety net is there if we don't save? The more important reason, however, relates to the fact that most Americans have already paid thousands of dollars each into the system, and expects their Government to honor its promise when they retire.

Is it possible, then, to change the current system into a viable business model, which honors all of the promises already made, maintains the current cost structure, and is acceptable by a vast majority of the American people? The balance of this paper is intended to offer such a model.

The Proposal

The President's plan calling for personal retirement accounts, using a portion of the current FICA tax, is a start in the right direction, but it lacks clarity and substance. Moreover, it is now caught up in a political debate, which has already confused the issues sufficiently to render the final outcome more than just uncertain, but very likely unacceptable to any of us who seek a permanent and final solution.

What I am proposing is a complete restructuring of the retirement system as it exists today and its integration into social security. I believe this proposal will be positively by most Americans.

Beginning January 1, 2006, every individual with a social security number will receive a Personal Account. Replacing the current 12.4% tax will be a 10% deduction from all earned income, 5% deducted from the individual and 5% from the employer. The entire 10% will be deposited into the Personal Account. The employer side would be a deductible expense while the individual side would not. The remaining 2.4% of the current tax 91.2% from the individual and 1.2% from the employer) will continue as a revenue item in the federal budget. The major departure from the current system is that the payroll deduction of 12.4% will be applied to an individual's entire wage base – not just on the first $90,000.

This Personal Account will belong to the individual worker, but governed by some very specific rules. Each Personal Account will have two sections. One half of the deposit (5%) will go into a Secured Section of the Personal Account in which the only available investment will be a one-year government guaranteed certificate. The Variable Section (which will receive the other 5%) may be invested by the individual worker into as many as five approved equity investments.

The Investment Alternatives

Funds going into the Secured Section of the Personal Account will receive a return equal to the higher of a U.S. Government one year Treasury Bill, a U.S. Treasury 5 Year Note, or a U.S. Treasury Ten Year Bond. The rate would change once annually, on the 15th day of the individual's birth month. In this way, the individual receives the highest return offered by most U.S. Government securities with no fluctuation of principal – and no risk.

The Variable Section will consist of index funds, qualifying mutual funds as well as the default choice of the one-year government guaranteed certificate. Congress will set the parameters for inclusion. For example, mutual funds must be diversified (as per the Investment Company Act), may not have front end, back end or other 12b-1 plans, and so forth. While there would be no limit on the amount invested in the government

certificate and certain broad index funds, to reduce risk - only 20% of the Variable Section may be invested in approved mutual funds or narrowly focused index funds.

The individual may make changes before noon on any day the securities markets are open. A secured method for making changes needs to be established. As long as the Government stays out of the business of advising, it could actually design and operate an online system similar to Schwab, E*TRADE, Ameritrade, etc.

Expectations

The typical person who begins work at age 25 and retires at age 65, with 10% of all pay going into this program, will have had deducted in total somewhere between $200,000 and $300,000 in today's dollars. Upper income individuals will have contributed well over $1 million.

Inflation, of course, could reduce the significance of these numbers. However, economic reality must also be considered. For example, when inflation is high, generally so are interest rates. The Secured Section should almost always receive a return exceeding the rate of inflation if the Federal Reserve continues to do its job of containing inflation. Except in periods of determined accommodation, FED policy generally strives to maintain short term interest rates above the rate of inflation. When short term rates do fall below inflation, the yield curve would almost always be steep, so that the 10 year bond would yield considerably more. Additionally, while equities tend to decline in periods of rising inflation (the short term), they also tend to adjust for inflation in the long run.

In today's dollars, then, there would be a very high probability that a worker in his/her twenties should expect a real return of at least 4% over their working careers. With the compounding effect of this return, the average workers will have accumulated over 41 million by retirement age, while for upper income workers it would be much higher, and many Personal Accounts would exceed $5 million over the course of individual's life's work. Of considerable importance is the fact that these returns, in today's dollars, would be tax deferred accumulations. The impact of this accumulation will be discussed below.

Benefits

Withdrawals from the Personal Account may be made as early as age 60, and must be taken no later than age 70. This would be entirely an individual's choice. An individual may elect to begin withdrawing only in the month of his/her birth, but any time between the ages of 60 and 70. Individuals who work past age 70 must make withdrawals, but they will also continue to fund their Personal Account.

Once withdrawals begin, the Variable Section of the account would be liquidated and the funds rolled over to the Secured Section. In other words, the principal in the account will

become a known quantity and that time, and at that time, it could be increased through additional deposits if the individual chooses to continue to work, even after making the choice of withdrawing.

Between age 60 and age 70, only up to the annual return on the Personal Account may be withdrawn. Since withdrawal may only begin in the month of birth, and since the rate of return is set at the same time, the 12 monthly payments going forward will be known and equal. Only if the rate of return changes twelve months out will the payments change. The impact of rates declining after this one year period would be minimized by the fact that most individuals continue to work between age 60 and age 70, so the principal of their Personal Account would continue to increase in value.

Between age 70 and age 80, all withdrawals must equal the rate of return plus 1% of the principal annually. Unless an individual continues to work past age 70, by age 0 the principal will be reduced by 10% from its value at age 70.

Between age 80 and age 90, annual (all paid monthly) payments shall total the annual return plus 2% of the principle. After age 90, monthly payments must be made based upon the current return on the account plus an annual amount of principle determined over the individual's life expectancy plus 5 years (at age 95 – plus 4 years – at age 100 – plus 3 years, etc.). For example, at age 90, the return from the Secured Section for the next year is added to a principal payment determined by calculating an individual's life expectancy plus 5 years.

From age 66 forward (the current retirement age), the minimum which may be withdrawn, if withdrawal is chosen to begin, is the amount of the individual would have otherwise received under the current social security system. In other words, no matter what is available in an individual's Personal Account, there is a minimum which must be withdrawn after age 66. That minimum will equal the promise guaranteed by the current social security system. If the Personal Account should be depleted at any point in time, a debit would be created in the

Account so that minimum payments will be maintained. That debit could be reduced if the individual had earned income. In any event, it would be wiped away upon the individual's demise/death.

Tax Consequences

All withdrawals are subject to taxation for all individuals at all levels of income, except that recipients have the choice of receiving either their itemized deductions or a standard deduction of $20,000 on the federal tax returns. In this way, retirees will not pay tax on the first $20,000 of retirement income. All current penalty and anti-productive taxes on social security payments should be abolished so as to simplify the tax code and make it much easier for people to plan their lives in the most meaningful ways.

When an individual passes away, his/her Personal Account may be rolled into his/her spouse's account with no tax consequence. When the spouse passes, the remaining balance is taxed at the highest bracket (currently 35%) and then distributed to his/her heirs. This may pass outside the will to the beneficiaries' names at the time of passing. Leaving Personal Accounts to charities will not eliminate the tax. However, no state or federal estate tax could be charged.

Impact of Accumulation

If a 25 year old worker will end up with $1 million (in today's dollars) in his or her Personal Account by age 65, and the Government guaranteed rate is 5% at the time, the annual payment (paid monthly) would amount to $50,000 ($60,000 after age 70) – well above the current expectation. While a 35 year old would receive less if this proposal takes effect today, the smaller amount would be minimized by the fact that 35 year old individuals generally earn more than 25 year old individuals. As a result, more is going into these Personal Accounts plus the fact that 35 year old individuals are more likely to have IRA's and other types of retirement vehicles which could be drawn upon at retirement. The same analysis holds true for those in their 40's.

It is only when you get those who are 50 to 55 years old in 2005 that the possibility exists that Personal Accounts will not have accumulated sufficient funds to make the minimum promised under the current social security system. Even here, however, these are prime earning years, and with no upper limit on the amount subject to the 10% contribution, most individuals over 50 will have deposited sufficiently to fund this minimum. Moreover, many people work well into their 60's and 70's, so that the impact of insufficient funding would be minimized.

The expectations for those high earning individuals; of course, are proportionally greater. Those in their 20's earning close to $100,000 and those in their 50's earning $300,000 or more annually, will accumulate $3 million or more by age 66. Their withdrawals will be proportionally higher.

So where's the Problem?

The problem, of course, is how to pay for those already on social security and not working to fund a Personal Account as well as those who will not have the opportunity to sufficiently fund a Personal Account to meet the minimum promised to them because of their age. Remember, the current system which simply transfers payments from those working to social security recipients, will no longer exist.

Integration

This proposed solution to the current social security system is predicated upon a major concession, i.e. deductibility of all current retirement plans would be eliminated. In fact, further contributions to IRA's (Roth or otherwise) would need to be abolished. Elimination of deductibility would essentially put closure to the entire retirement plan system, and reduce the inequities between employers who sponsor them and those who don't.

No contributions to these plans may be made after January 1, 2006 and all plans must be terminated by January 1, 2007. All monies currently in these plans (i.e. 401K's) would be rolled into individual IRA's, except defined benefit pensions. Defined benefit pensions would remain intact except that no further deductibility would apply to contributions (i.e. most employers would freeze the benefit). By 2007, individuals would possess a single IRA (and a Roth if they previously set one up) and a defined benefit pension if they had previously participated in one. There would be no change in the rules governing withdrawals from these.

Paying the Piper

So how do we fund the unfunded social security benefits (i.e. those individuals over 50 who may not be able to receive the minimum promised them if they had to rely exclusively on the new Personal Account)? It is important to remember that most of the individuals over 50 and currently working will be able to fund all or the majority of this obligation.

The first thing to do is to get a handle on the amount we are talking about. Unlike the current state of affairs, which would continually and increasingly worsen beginning in 2008, we will now be able to come up with a fairly accurate number for the entire liability. We will know conclusively that this number will shrink over time. Currently, that liability is approximately $450 billion annually.

So what is to become of this $450 billion liability in year one? To Begin, there still remains the 2.4% which would continue to transfer from those working to those receiving benefits. This should amount to approximately $125 billion annually and will grow annually. In addition, with the 2.4% applying to the entire wage base, not just the first $90,000, and another $50 billion annually would be available. A second source of funding the liability would be the additional tax collected by the federal government due to the elimination of deductibility on all retirement accounts. This should amount to another $150 billion annually.

The final source of funding would be the taxes collected on all distributions from Personal Accounts, including the tax collected on final distributions to heirs. This would

be very little in the initial years, perhaps about $25 billion, but it would be significant 15 years out.

If we look at the sources of funding in the first years of this proposal, we find that the additional revenue ($125 billion plus $50 billion plus $150 billion plus $25 billion) still falls short about $150 billion annually of meeting the current $450 billion annual deficit. Again, it is important to note that the revenue will rise every year while the $450 billion deficiency will be reduced. In my estimation, it would take 7 to 8 years to reach the point where revenues will equal expenditures. It would take only another 4 to 5 years to reduce and eliminate the total liability created. In just 11 to 13 years, this entire issue could disappear entirely. In other words, while this proposal would increase the current deficit in the first 7 to 8 years, it contains within itself (without increasing a single tax) the mechanism to pay it off in its entirety. Thereafter, 2.4% of the current FICA tax could be eliminated.

Although it will be guaranteed to be temporary, (i.e. the deficit which would be created in the initial years would be repaid in the out years without any tax increases) the 2.4% tax could be ultimately eliminated. The fact that this would increase the deficit by another $150 billion in the initial years will be the primary issue raised. This will be the essential argument against this proposal. Many will argue that increasing the deficit will be inflationary, in spite of the fact that Personal Account deposits will go into savings, not consumption.

Getting this through Congress may require some modest adjustments. For example, individuals in their 20's could receive deposits into their Personal Accounts equaling 8% of their pay with 4.4% going to pay down the liability. Individuals in their 30's would receive deposits equaling 9% of their pay with 3.4% going to pay down the liability. In one fashion or another, this proposal can be adjusted to accommodate those arguing against it. However, the final result will be the same in that the social security problem will be resolved.

Meeting the Goals

I started this discussion with the premise that this proposal will save the social security system. Indeed it does, but will those who will benefit the least oppose it? I believe that they w ill not oppose it for a number of reasons.

There should be no question that this proposal not only meets but exceeds the President's goal of creating Personal Accounts for every individual. These assets, subject to withdrawal rules, can be passed on as well as grow over one's lifetime with virtually no risk to the principle.

This system is relatively simple as it reduces the Social Security Administration personnel considerably. In addition, it eliminates the heavy administrative cost of corporate retirement plans as they exist today. Finally, it is not counter-productive in

terms of individuals who choose to work beyond age 66. It treats everyone evenly and fairly, correctly balancing a lifetime of work with the retirement benefit.

How will individuals with different incomes view this proposal? There are essentially two major categories into which an individual will fall – those earning less than $90,000 annually and those earning more than $90,000 annually. For those earning less than $90,000 this proposal should be a slam dunk. It guarantees them a minimum of what they are entitled to under the social security plan as it currently exists, with no increase in cost. In fact, for the vast majority, perhaps as many as 90% of these individuals, they will receive considerably more benefit from their Personal Accounts than they are entitled to under the current system. In addition, they will be able to leave a legacy fund to their children.

What they give up is the ability to add to their IRA's, most of who do not currently have them. Employer sponsored plans would also disappear. However, the final benefit under this proposal (in almost every instance) will exceed what they could expect to receive from the combination of the current retirement plan system (401K's, IRA's, etc.) and the current social security benefit. Opposition from this group would not be based on rational considerations.

For those earning more than $90,000, the cost would rise over the current program. For every dollar earned over $90,000, 2.4% would be taxed with an additional 10% deducted and deposited into the individual's Personal Account. However, under current rules, for those with very high incomes, income deductions going into retirement plans are limited to no more than $30,000 annually. Under this proposal, an individual earning $700,000 (for example) would receive a $70,000 deposit into their Personal Account. Although half of this would not be deductible, the tax deferred compounding on that $70,000 would be worth much more over time.

Additionally, many high income individuals own their own businesses. The elimination of most of the current retirement system would also relieve them of the associated costs, although the expectation is that part of the savings would be passed along to employees in the form of higher pay, and this may just be one of those unexpected benefits to come out of this plan. Of equal importance will be the greater sense of wealth Americans will experience. This will result in more consistent spending and consumption patterns. This, in turn, should reduce the negative impact of recessions.

In the end, knowing that we are giving our children and grandchildren a solid and meaningful retirement system (fair to everyone) is the ultimate return. The elimination of a 2.4% tax in about 11 to 13 years is nothing to sneeze at either.

Date

Date