THE DAILY CALLER

Why economic growth depends on reforming Social Security

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Rivers of red ink continue to flow from the federal budget, and we still face an entitlement spending crisis. But you wouldn't know it from the priorities of the two political parties: President Obama has been busy pushing for more "investment" spending, and the Republicans have been consumed by the administration's scandals.

I'm all for investigating scandals, but the fuse on the entitlement time bomb is getting shorter all the time. Let's look at Social Security. Its unfunded obligations are a mindboggling $23 trillion, and everyone agrees that the sooner we start tackling this problem the better.

There is another reason why Social Security reform should be a priority: The program causes ongoing damage to the economy by distorting labor markets and reducing savings. America desperately needs stronger economic growth, and we can get it by overhauling Social Security, as I discuss in a new study for Cato's DownsizingGovernment.org.

The first thing to understand is that Social Security's 12.4 percent payroll tax puts a large wedge between what employers pay for workers and what workers actually receive. That artificially increases the cost of hiring, which in turn reduces employment and results in lower overall production in the economy.

What exacerbates the problem is that Social Security taxes are piled on top of income taxes, with the result that millions of families face very high marginal tax rates on their earnings. This is important because the harm (or "deadweight loss") of taxes rises rapidly as marginal tax rates rise, and so the combination of payroll and income taxes causes major labor market damage.

Harvard University's Martin Feldstein estimates that every dollar of increased payroll taxes causes about 50 cents of added deadweight losses. So let's say that Congress raised the payroll tax by two percentage points to help "fix" Social Security's finances. That hike would not just hit workers with an extra $120 billion in annual taxes, it would also cause $60 billion of damage to the economy from labor market distortions.

The good news is that there is a way to reform Social Security that would both fix its finances and reduce the economic damage. That is to convert Social Security to a system of personal retirement accounts, as more than two dozen nations have done since Chile pioneered such reforms three decades ago. The reforms have shown that privatized retirement systems can benefit workers, retirees, and the overall economy.

Chile's personal retirement accounts are funded by contributions of 10 percent of wages. Because workers own these funds, it greatly reduces the labor market damage — or deadweight losses — caused by the system. Chilean workers can look at their paystubs and see that their earnings are going into a secure account that will benefit them. That acts as an encouragement to work. By contrast, in our system Social Security taxes go into a government black hole, which simply frustrates workers and reduces work effort.

Another economic distortion caused by our Social Security system is that it doesn't create a pool of savings for the economy as private pension plans do — the program simply taxes and spends. With a smaller pool of savings in the economy, the nation's capital stock is reduced and productivity is suppressed.

To appreciate this, consider how generations of Americans have grown up assuming that the government will take care of them in retirement. As a result, they consume much more when they are young, and put less money away for when they are old. Social Security and other welfare-state programs encourage people to become spendthrift and to become too dependent on the government when they retire.

If we switched to a Social Security system based on personal accounts, it would get people into the habit of saving, while engaging them in active planning for their own retirement. It would give Americans more responsibility and control over their own financial futures.

For the broader economy, savings are the seed corn of growth because saved funds are channeled by the financial system into business investment. Thus switching from the current anti-saving Social Security to a pro-saving personal account system would be a huge spur for investment and job creation in the economy.

In sum, the current Social Security system is not just financially unsustainable, it is also economically damaging. So let's phase out this nanny state retirement program and move to a system where individuals take charge of their own retirements. Let's allow young people to build a more secure nest egg for themselves, while spurring higher economic growth, to everybody's benefit, at the same time.

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