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Responding to Mike Tanner on Social Security Reform

by Andrew Biggs

Over at National Review, the Cato Institute's Mike Tanner and I have been involved in a friendly back and forth regarding how conservatives and libertarians should think about Social Security reform. While Mike and I hardly represent the broad spectrum of views on Social Security, and maybe not even the full spectrum on the right, I think it's a worthwhile discussion because the issue is ripe (Social Security ain't about to fix itself) and conservatives may soon have the chance to have their voices heard again on the issue, either through the fiscal commission or through a potential Republican majority in the House. Mike initially wrote on the issue in his National Review Online column; I commented in an NRO piece this morning; Mike has some additional comments at The Corner. Here I'll respond to what Mike writes at The Corner.

Broadly speaking, our discussion is more about costs and benefits than basic philosophy. Both of us have favored Social Security reform that includes personal accounts. The question is whether the gains from accounts-based reform—in policy terms, financial terms, and philosophical terms—are worth the political capital involved in passing it. I've come to the conclusion that they aren't.

Mike's first point is that, even if personal accounts-based reform wouldn't pay a higher return overall—that is, they wouldn't make Social Security "a better deal"—they are a benefit to low earners who currently don't hold stocks. I basically agree, since there are benefits, both financial and in terms of political risk, to diversifying your retirement savings. Diversification, not higher returns, is one way that accounts could have been sold in the past. That said, some economists I trust argue that the gains would be pretty modest. Certainly, the improvement for low earners wouldn't be anything near the increase in expected rates of return, which are mostly a function of the increased risk of stocks. So I grant the point, but I just don't think the welfare gains are big enough to justify the massive political costs in trying to pass personal accounts.

Second, I argued that personal accounts funded by additional borrowing wouldn't be of real benefit, either to individuals or the economy, and that while accounts funded by spending cuts would be of benefit, it's the spending cuts rather than the accounts that would be doing the leg-work here. Mike counters with a political economy argument that it will be hard to cut spending unless voters know where the gains will go to, and so accounts may be an essential tool. But you can just as easily argue that rising entitlement spending *already* has squeezed out other government outlays. Non-defense discretionary spending fell from around 5 percent of gross domestic product (GDP) in 1980 to around 3 percent in 2008 (before shooting up in the past two years, due to rising spending and a fall in GDP). My guess is that the Left can't raise taxes sufficiently to cover rising entitlement costs, so discretionary spending—defense and non-defense alike—will fall further. I can buy the argument that accounts might help reduce government spending, but I'm less sure that they're the only thing that can.

Mike also rightly argues that there are non-financial benefits to personal accounts that shouldn't be ignored. I strongly agree, and actually wrote on this for AEI back in 2002. An ownership society has both practical and philosophical advantages that shouldn't be ignored. But, again, there are issues of costs and benefits: back in 2005, President Bush all but said he was willing to increase Social Security taxes—specifically, the maximum wage on which taxes are paid—as part of a package to pass personal accounts. Accounts promote individual ownership and freedom while taxes detract from them, so it comes down to how much you get of each.

Finally, Mike presents the political case: that my approach—which essentially says to fix Social Security by reducing benefits, then add universal 401(k) accounts on top—comes down to "eating your spinach," while accounts-based plans have some "ice cream" to go with it. Also true, but it again comes down to trade-offs. Social Security has a 75-year deficit of around 2 percent of payroll and a tax of 12 percent of payroll, so to balance the system without raising taxes you'd need to cut benefits by around two-twelfths, or 17 percent. That's roughly how much my approach could honestly be accused of cutting benefits (in practice it would be accused of cutting much more, but that's politics). Now let's add a personal account investing, say, half the total payroll tax. To keep the accounts from making Social Security's deficit worse, each account holder would need to give up roughly half his traditional benefits (actually more, but it's a technicality) in addition to the 17 percent he'd give up to fix solvency. So instead of being accused of cutting traditional benefits by 17 percent, you'd be accused of cutting them by at least 67 percent. It's not a particularly honest accusation, since the account would pay benefits too, but in any reform debate that's the accusation that would be made. And it carries a real political cost.

As Mike points out, neither of us are political experts—and on this issue, I'm not even sure that political experts are political experts. My back-of-the-envelope, seat-of-the-pants, cost-benefit analysis tells me that a better approach, both politically and policy-wise, is to focus on holding down rising Social Security benefit costs and holding the line on taxes. That's something I think would hold together a natural center-right coalition on reform, which was lost during the Bush administration reform drive in 2005. Only time will tell, but I think these sorts of friendly discussions will be useful on a range of issues going forward.

The problem with this line of reasoning is that, while economically sound, it ignores political reality. It assumes that spending could be reduced by identical amounts in the presence or absence of Social Security reform. But if Congress had the will to reduce spending, it would have done so.

Regarding spending, one thing that's interesting is that non-entitlement spending has already fallen as entitlements have grown in size. Part of that comes from the military, which I generally don't think is good, but part has come (and probably more will come) from the discretionary side, which I'd guess is the most wasteful part of the budget since it's the part Congress has the most control over. So in a sense we are starving that beast, albeit through higher entitlement spending rather than tax cuts. If accounts were a sure-fire (or at least good bet) at cutting spending I'd be more favorable, but I'm just a little skeptical that it would happen. During the 2001 Commission we made the case for using accounts to increase national saving, boost the economy, etc. But once Bush got serious about reform all of that went out the window and the just decided to borrow the cash.

The political consideration between add-ons and carve-outs isn't necessarily spinach and ice cream, since with a carve-out the "cuts" to traditional benefits will be larger in order to keep the accounts from hurting solvency. Let's say that if the deficit is 2 percent of payroll then a non-accounts plan would need to cut benefits by roughly that amount. An accounts plan needs to cut defined benefits by 2 percent, plus whatever the account size is. We both know that what matters is total benefits, but the Left will say that it's a huge benefit cut, etc., while ignoring the account. That's a political hurdle. I also think that people are much more favorable to putting their own additional money into accounts versus more money in taxes, relative to wanting to shift their existing payroll taxes into accounts. It doesn't make much sense, but that's my gut on things.

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