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The Washington Times

DAVIES: Payroll tax-cut cacophony

Saving the system with an opt-out choice

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The Washington Times

Monday, January 3, 2011

The temporary 2-percentage-point cut in payroll taxes that will begin with the new year has Social Security defenders howling that the cut jeopardizes the long-term survival of the program. By stepping solidly on what previously was the third rail of politics, the tax-cut proposal is one of the bravest political moves seen in years. Finally, we can proclaim what before we would only whisper: Nothing can jeopardize the long-term survival of Social Security because Social Security as we know it is terminal.

Social Security proponents defend the program by making the debate about the higher returns from private retirement versus the safety of a public retirement system. This return-versus-safety debate is a red herring. Social Security's claimed safety comes from the fact that Social Security surpluses are invested in Treasury bonds. However, the only guarantee you have is that Social Security surpluses will be invested in Treasury bonds. There is no guarantee that Social Security will pay you the money it invests.

For evidence, look to 1983, when the government changed the law to make Social Security benefits taxable. If Social Security benefits were not taxed, a retiree who had taxable income of $30,000 and Social Security benefits of $18,000 would owe about $1,900 in income tax (assuming the worker filed as a head of household). Now that Social Security benefits are taxed, that retiree owes $3,200 in income taxes. Making Social Security benefits taxable effectively reduced the retiree's Social Security benefits by $1,300 and allowed the government to default on a portion of its Social Security obligations. Those who want the safety of Treasury bonds don't need to go through Social Security - anyone can purchase Treasury bonds directly on bond markets. When you purchase Treasury bonds directly, you are guaranteed that you will get back every dollar you invest, plus interest.

Social Security was conceived as a safety net for the poor and the aged, yet the median household purchasing power today is almost three times that of 1940. When Social Security was instituted, life expectancy was eight years beyond retirement. That would be the equivalent of a retirement age today of 72. Over time, benefits have increased and the ratio of retirees to workers has grown such

that the program is no longer sustainable. What we need is a way to wean the country off of Social Security. The appallingly low return on Social Security contributions suggests a way out.

If we gave each person the option of leaving the Social Security system at age 32 or after paying into the system for 10 years (whichever came later) in exchange for giving up all past Social Security withholdings and all claims to future benefits, we could both reduce the number of future beneficiaries and extend the life of Social Security for those choosing to remain in the system. In today's dollars, the average 32-year-old can expect to pay $180,000 into Social Security from age 32 to his retirement and to receive $390,000 in retirement benefits. For each 32-year-old like this who opts out of the system, Social Security saves more than $200,000.

Social Security is such a poor investment that the average 22-year-old would be as well or better off paying into Social Security for 10 years and, at age 32, forfeiting all his retirement benefits and all the money he paid into Social Security during the previous decade in exchange for being allowed to keep his future Social Security taxes and invest them privately. The accompanying chart shows the retirement benefits the 22-year-old could expect from staying in the Social Security system compared to the benefits he could expect from opting out of the system at age 32 and investing what would have been his future Social Security taxes in AAA-rated bonds. At retirement, he can expect retirement benefits that are 40 percent greater than the retirement benefits he would have received had he stayed in the Social Security system.

Before the 2-percentage-point cut in payroll taxes, the Social Security Board of Trustees estimated that Social Security, under the current law, would be insolvent by the time today's 40-year-olds reach retirement. Tax-cut opponents are correct that the proposed cut will hasten Social Security's demise. But that is exactly what we need. Social Security as we know it cannot be saved. In our remaining 20 to 30 years, we need to bite the bullet: We must honor our commitments to current retirees, and we must get as many of today's workers out of the system as possible. Asking workers to pay into Social Security for 10 or more years and then providing the option to walk away in exchange for diverting their remaining taxes into private accounts is a good way to start.

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