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WHY DEMOCRATS OPPOSE BUSH.

Personal Dispute

by N. Gregory Mankiw

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Harvard University is, by some measures, one of the most left-wing institutions on the face of the earth. So you may be surprised to hear that it has endorsed George W. Bush's proposal for Social Security reform. Literally, of course, that is not true. But the retirement plan Harvard has set up for faculty members like me bears a striking resemblance to what the Social Security system would become under the president's proposed changes.

Harvard's retirement plan is essentially the nonprofit sector's version of a 401(k). Each year, the university puts a certain percentage of my income into my retirement account. I then invest this money in low-cost mutual funds, which hold a diversified portfolio of stocks and bonds. I can choose a safer portfolio with a lower expected return or a riskier portfolio with a higher expected return. The money is mine, even if I decide to leave the university. If I die, I can leave it to my kids. When I retire, I can use it to buy an annuity to ensure a stream of income for the rest of my life.

Under Bush's proposal, you would have the option of diverting some of your payroll taxes into a personal retirement account. You would invest this money in low-cost mutual funds, which would hold a diversified portfolio of stocks and bonds. You could choose a safer portfolio with a lower expected return or a riskier portfolio with a higher expected return. The money would be yours, no matter how many times you changed jobs. If you died before collecting any money, you could leave your account to your kids. When you retired, you could use it to buy an annuity to ensure a stream of income for the rest of your life.

Historically, Social Security has been a defined-benefit system. You put money in when you are working, the government promises you an income when you retire, and, in the meantime, the feds take care of everything. Bush is proposing that Social Security gradually evolve into a defined-contribution system, where money is put in your account and then you watch over your own retirement assets.

I am perfectly happy with Harvard's retirement plan. I have the sense that my colleagues at Harvard are happy with it as well, as are millions of other workers who have similar arrangements. This raises the question: If the liberal Harvard faculty is content with the defined-contribution structure for their private retirement income, why are liberals in

Congress (and the liberal NEW REPUBLIC, for that matter) so appalled that Bush would propose moving the public retirement system in the same direction?

As far as I can tell, there are three reasons. The first is that the president proposed it, and some Democrats will oppose anything he advances. Many hope that Social Security reform will do to Republicans what Hillarycare did to Democrats: hand the president a defeat so humiliating that it would undercut his ability to set the domestic policy agenda. It is not hard to imagine that this outcome would affect midterm elections and perhaps even alter the balance of power in Congress.

The second reason the left hates personal accounts is that, over the long term, they could destroy one of its favorite battle cries: the alleged conflict between evil capitalists and oppressed workers. ("Workers of the world unite; you have nothing to lose but your chains.") No ambitious political figure today would be stupid enough to quote Marx, but let's face it, much of the left's rhetoric is a less elegant paraphrase of his worldview.

Social Security reform could put a stake through the heart of this populism once and for all. After workers develop an equity stake in corporate America, they will start watching CNBC and the "Nightly Business Report." Their view of how they relate to the economy will fundamentally change. Bush understands this, and it is one reason he talks about an "ownership society." Democratic leaders understand it as well. Their biggest fear is that a nation of stockholders could easily morph into a nation of Republicans.

The third reason for the left's opposition to personal accounts is simple paternalism. Liberal critics of the Bush plan may be willing to accept that Harvard professors are capable of investing sensibly for their own retirement, but they are not ready to trust the general public to do the same. Compared with Republicans, Democrats are more averse to an economic system in which people play a larger role in taking care of themselves. To be sure, the paternalists raise a valid concern--some segments of the population are not economically sophisticated--but this is not so much an argument against personal accounts as a reason why we need to get the details right. Any reform should include some restrictions to protect people from themselves. There should be limits on how much risk people can take in their portfolios, especially as they approach retirement. There should be requirements that people annuitize enough of their accumulation upon retirement to ensure they are kept out of poverty for the rest of their lives.

Of course, when Democrats speak publicly, they are rarely this frank. They will not readily admit to political opportunism, to opposing the spread of stock ownership, or to distrusting the public with its own money. So, instead, they raise two canards--one involving the deficit, the other involving risk.

Opponents of Bush's proposal say that funding personal accounts will require irresponsibly large increases in the budget deficit. This argument, however, is mostly fatuous. For one thing, the president is proposing to phase in the new system gradually. Eventually, everyone would be able to place 4 percent of their wages (up to the maximum of taxable earnings, which today is about $90,000) into a personal account. But, initially, the contribution would be capped at $1,000 per year, precisely to calm fears about the short-run budget impact.

More important, under the president's proposed policy, the long-run impact of personal accounts on the government's finances is approximately zero. When a person signs up for a voluntary personal account, the government puts, say, $1,000 in his or her account. In exchange, that person agrees to receive lower benefits from the traditional defined-benefit system, by an amount equal to $1,000 in present value. The initial payment into the account requires $1,000 in extra government borrowing, but that debt is offset by a reduction in the government's liability to pay future Social Security benefits.

All economists will tell you that the government faces a budget constraint that is expressed in terms of the present value of current and future cash flows. If a worker takes more out of the system today and agrees to take less out in the future--and those two changes balance in present value--then the government's finances are neither better nor worse than they were before. Higher budget deficits in the near term are balanced by smaller deficits or larger surpluses further out. In essence, the establishment of personal accounts recognizes an existing liability rather than creating a new one.

Some economists go so far as to suggest that the borrowing to finance personal accounts is an advantage of the proposed reform. One problem with traditional Social Security is that liabilities are implicit and, therefore, easy to ignore. Politicians have found promising higher benefits too attractive, because the cost of those benefits has been too well-hidden. Indeed, the funding shortfalls now facing Social Security are like those many companies face with defined-benefit pension plans. Recognizing these problems, younger businesses are more likely to set up defined-contribution plans like Harvard's. A defined-contribution system is more transparent--the worker knows what he is getting, and the employer knows what he is paying. Greater transparency should also be a goal for the federal government's finances.

The second canard raised by critics of the president's proposal is the claim that it would leave retirees of the future facing too much risk. They argue that personal accounts would leave the safety net for the elderly with too many holes. The most obvious response is that the proposed personal accounts are voluntary. If you want to stay in a traditional defined-benefit plan, just don't opt in. And, even if you opt in but then want a low-risk retirement income, you can invest in inflation-indexed Treasury bonds.

Most financial planners, however, recommend that everyone invest at least a portion of their retirement resources in equities. Sure, this means higher risk, but the risk is compensated for by a higher possible return. Harvard faculty can decide for themselves how much risk they are willing to bear. Personal accounts in Social Security would expand the number of Americans given this choice.

One important risk that reform could reduce is the uncertainty about future benefits that arises from the vagaries of the political process--a type of risk that does not yield a higher return. Proponents of the current system like to say that it offers a guaranteed retirement benefit. But how guaranteed is that benefit when the system is so vastly underfunded? President Clinton talked about the "fiscal crisis in Social Security" in 1998, but no changes in the system were enacted. (Reliable sources tell me that Clinton's inaction on Social Security was in part a payoff to the left wing of his party for its support during impeachment.) Now, seven years later, Bush is trying to address the problem, but many in Congress want to kick the problem down the road yet again. In light of the political uncertainty, it is preposterous to view the current system as low-risk.

But, if personal accounts are not the irresponsible budget-busters that the left claims, nor are they the free lunch that some on the right seem to believe. The simple demographic facts are that Americans are having fewer children and living longer. As a result, the ratio of workers to retirees has fallen from 16 to one in 1950 to 3.3 to one today, and it is expected to continue to fall. Clearly, in retrospect, it was insane to set up a retirement system with a fixed retirement age (which now is slated to rise very slowly). Imagine if, instead, Franklin Roosevelt had set up a Social Security system in which the youngest 90 percent of the population agreed to support the oldest 10 percent--and those percentages were fixed over time. Such a system would have been better able to withstand changes in demography.

Unfortunately, that is not the system we inherited. The current system has a path of projected revenue and a path of promised benefits that do not line up. It will start running deficits around 2018, and those deficits will grow larger indefinitely. Under current law, when the trust fund runs out around 2042, benefits will be cut automatically by about 25 percent for everyone, including those already retired. At that point, there will be a battle among the generations--the outcome of which is anyone's guess. Those interested in semantic games can argue about whether this situation is really a crisis, as Clinton and Bush have called it, or simply a problem. But there is little doubt that the aging of the population has put the federal budget on an unsustainable path, and the sooner we act, the better.

Bush made clear in this year's State of the Union speech that personal accounts by themselves will not solve the funding problem. The solution will have to include some combination of slowing the growth of benefits, increasing the age of eligibility for benefits, or raising taxes. The president has rejected increasing the payroll tax rate, but he has left on the table raising the cap on taxable payroll. I have met no Republicans who like this idea, but it may be the price of convincing a few moderate Senate Democrats to support change.

Some have asked, if personal accounts will not fill the shortfall in Social Security's finances, why talk about them? The answer is that, once major Social Security reform is on the table, we should take the opportunity to improve the system in any way we consider prudent. When you bring your car into the shop for a new muffler, you shouldn't complain if your mechanic points out that your brakes are shot. Once you have brought the car in, you should want to fix all the problems that need fixing.

The same principle holds for public policy. We need to fix Social Security's funding problem, and that will require hard choices. But we should also make it a better system for future generations. Moving the system gradually from defined-benefit to defined-contribution would be a good step, giving people more choices and the government greater transparency. The funding problem is the catalyst for reform, but the nation should take this opportunity to give all Americans a retirement system as reliable as the one Harvard gives its faculty.

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