BusinessWeek

APRIL 4, 2005
ECONOMIC VIEWPOINT
By Robert J. Barro


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Why Private Accounts Are Bad Public Policy

Social Security promises too much now. So why enlarge it?

I once thought personal accounts for Social Security were a good idea but have changed my mind. Personal accounts have some virtues, but the common arguments, both pro and con, are myths. Overall the accounts are a bad idea.

The strongest points for personal accounts involve property rights and the freedom of choice. When people contribute to a personal account, property rights insulate benefits from future Congresses who can change the program as they wish. The rights also mean that, unlike the current program, the contributions are not a tax that discourages work. Personal accounts also allow for differing preferences on which assets to hold, how much risk to take, and when to receive income. Forcing everyone into a one-size-fits-all plan is usually unwise.

Advocates of personal accounts cite the low rates of return in the current system, but this is misleading. Prospective returns to young people are low mostly because we gave benefits to older generations of retirees who did not contribute their share of taxes to pay for them. One way or another, the burden of this generosity has to be borne by the young. From the perspective of the trust fund, returns look low because the fund's government bonds have paid less than stocks. But the premium on stocks is compensation for risk, as gauged by financial markets. Although the ability to hold stocks is a plus, there is no free lunch of assured higher returns.

Another myth is that these accounts enhance saving and economic growth. In fact, tinkering with Social Security won't have major effects on national saving, investment, or growth.

An opposing myth is that the transition requires too much government borrowing. In fact, a debt-financed transition entails substitution of explicit liabilities (government bonds) for unfunded liabilities (future benefits in the present system). There are no substantial effects on interest rates, national saving, and the current-account imbalance.

A SERIOUS ANALYSIS STARTS with asking why we have Social Security. If we were not so used to it, we would find it odd for the government to collect money from young workers and give it to the old (mostly workers' parents). One rationale is that the government should help people who lack discipline to save for old age. I have never embraced this paternalistic view. It's true that society will inevitably provide welfare to the needy elderly. Knowing this, some people will save too little and rely on public support when old. Thus, there is reason to require workers to save for retirement. How much depends on what is viewed as a minimal standard of living; suppose it is $1,000 per person per month. (Currently, a person with the median earnings history gets $1,200 from Social Security.)

Contributions that fund just the minimum cannot go into a meaningful personal account. People would opt for too much risk, knowing they would be bailed out if they fell short. Also, contributions that cover the minimum provide no individual return and, therefore, amount to a tax that discourages work.

Personal accounts have to supplement the minimum payout. But then why have a public program at all, rather than relying on individual choices on saving? I think there is no good reason to go beyond the minimum standard; that is why I view personal accounts as a mistake -- they enlarge a Social Security program that already promises too much.

To provide an acceptable standard of living, baseline Social Security benefits should be indexed to prices. The practice of indexing initial benefits to past wages should be eliminated. Moreover, the price index should be an accurate one, such as the Bureau of Labor Statistics' chain-weighted consumer price index, rather than the standard flawed index. In addition, the normal retirement age should effectively be indexed for changes in life expectancy, going beyond the current plan to raise the age to 67. These three adjustments are all-important. Together, they more than suffice to "save" the current Social Security program.

A mistake even greater than personal accounts would be, in addition, to raise the maximum earnings taxed by Social Security above the current $90,000, a proposal that President Bush seems to welcome. This change increases marginal tax rates by about 10 percentage points on a productive group that already faces high marginal rates. Not a good idea for economic growth. President George W. Bush should remember the line, "Read my lips -- no new taxes," and take it more seriously than his father did.

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution
(rjbweek@harvard.edu)