THE CASE FOR PRIVATIZING SOCIAL SECURITY
Managing the Transition and Implications for Industry

[T]he types of changes that will be required to restore fiscal balance to our social security accounts are significant but manageable. More important, most entail changes that are less unsettling if they are enacted soon, even if their effects are significantly delayed, rather than waiting five or ten years or longer for legislation. . . . If we procrastinate too long, the adjustments could be truly wrenching. Our senior citizens, both current and future, deserve better.

Testimony of Chairman Alan Greenspan before the Task Force on Social Security of the Committee on the Budget, U.S. Senate, November 20, 1997.
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THE CASE FOR PRIVATIZING SOCIAL SECURITY
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BRIEF FOR EXECUTIVES

Less than 15 years after its last major reform, Social Security again faces serious financial problems. According to the government’s best forecasts, an immediate payroll tax increase of 2.23 percent of payroll would be needed to keep the program solvent for the next 75 years. Although the program may not begin running significant deficits for another two decades, making changes now will reduce the cost of reform.

Social Security faces a significant demographic problem. Increases in life expectancy and falling birth rates will lower the ratio of workers to retirees. This gradual aging of the workforce will place large strains on Social Security and Medicare, especially when the first Baby Boomers retire around 2010. Attempts to maintain a high minimum level of retirement benefits to all retirees will require policymakers either to lower the rates of return current workers receive on their payments into the system or to increase the progressivity of the system, making Social Security more of a poverty program.

Since its inception Social Security has aimed at universality. But as the Baby Boomers retire its universal nature will increasingly place policymakers in an uncomfortable dilemma. Insisting on paying benefits to all retirees, regardless of need, will reduce the resources available to poorer elderly and require large increases in payroll taxes. At the same time, large payroll taxes reduce the living standards of the nation’s poorest workers and make it harder for all workers to save for their own retirement.

A few reforms make sense, even given the original nature of the program. First, increased longevity and changes in the nature of work justify speeding up rises in the retirement age and linking it to future increases in average lifespans. Second, given evidence that the Consumer Price Index (CPI) overstates the true rate of inflation, Congress should index benefits to the CPI minus 0.5 percentage points.

In the long run, Social Security cannot continue trying to help workers save for their own retirement and also redistribute large amounts of income between generations. The nation will continue to need a program for assisting the low-income elderly but this should be financed out of general revenues, and benefits should go only to those who need them, regardless of whether they have reached retirement age.

With regard to helping workers save for retirement, the government’s role should be minimal other than to allow workers to shelter savings from immediate taxation. Modern financial markets ensure that all workers will benefit if they are allowed to participate directly in the generation of wealth by investing a large percentage of their current payroll taxes in a diversified portfolio of stocks and bonds. The private markets will continue to offer investors higher returns than they can get anywhere else, provided they hold a well-diversified portfolio for the long term. Mutual funds now offer the average investor the ability to create such a portfolio at very low costs. Allowing every worker to take advantage of this opportunity will ensure sufficient retirement income for all but the poorest workers. Workers are also likely to save more if they are given personal accounts. Government assistance should continue to be available to both workers and retirees living below the poverty line.

The gradual transition to a private system should require modest sacrifices from current beneficiaries. An increase in the national debt will also be necessary to spread the burden out over a longer period of time. Such an increase should be seen as an attempt to limit future financial liabilities by bringing them forward and financing their cost. Even a greatly increased debt load is manageable if it accompanies long-term reform of the nation’s entitlement programs, and is accompanied by a commitment to run federal budget surpluses, with the surplus used to repay the debt.
THE CASE FOR PRIVATIZING SOCIAL SECURITY
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Introduction

Social Security is the crowning achievement of the progressive, proactive approach to government that characterized American politics from President Roosevelt’s New Deal through the implementation of President Johnson’s Great Society. The program began as a modest income-maintenance program intended to provide a floor of support for the elderly funded with very low tax rates on current workers. Today, Social Security is by far the largest and best established federal program. In fiscal year 1997, Social Security outlays consumed 23 percent of all federal spending. Payroll taxes dedicated to the program accounted for over 25 percent of all federal revenues.

Over the past several decades the program has made an important contribution in reducing poverty rates among the nation’s elderly and has significantly raised the living standards of millions of individuals. The benefits have extended beyond the elderly. Social Security also provides income support to families whose main provider has died and, through disability insurance, to those who are no longer able to work. Many middle-aged workers would have had to provide significantly more financial support to aging parents were it not for the program’s retirement benefits.

All of this has come at a cost. Social Security has been sustained only through periodic increases in both the rate at which wages are taxed as well as the amount of income subject to the tax. In 1998 Social Security payroll taxes will claim 12.4 percent of all wages up to $68,400.1 There is evidence that the availability of Social Security and other federal retirement benefits has reduced both the ability and willingness of workers to save on their own, contributing to a decline in the national savings rate.

Social Security has also constrained our ability to deal with other policy problems. With few politicians currently advocating a net expansion in government spending, let alone the tax increases needed to pay for it, any additional funds devoted to emerging national problems must come from reductions in existing programs. As stated above, Social Security now ties up 23 percent of current federal spending (29 percent excluding interest on the national debt). The nation would probably benefit if some of these funds were carefully channeled to other problems such as family support, education, and health care. The politics of Social Security make this extremely difficult, however.

These problems aside, it is increasingly clear that, without significant reforms, Social Security is unsustainable in the long run. Although the program is currently running surpluses, by 2012 its annual revenues will be insufficient to pay all benefits.2 From this date on, Social Security begins costing the government money. Even if one gives Social Security credit for the interest payments on the Trust Fund into which current surpluses are deposited, outlays will begin to exceed total revenues by 2019. At this time, Social Security could begin selling assets from its Trust Fund, although these sales would place a greater strain on the rest of the federal budget. Even then, however, Social Security is expected to exhaust its Trust Fund in 2029. After that, Social Security taxes will be sufficient to pay only 70-75 percent of annual outlays.

There are two points on which virtually everyone is agreed. First, Social Security must change in order to avoid insolvency. Different suggestions focus on benefit cuts, tax increases, or, most often, a combination of both. Second, although its Trustees expect Social Security to remain solvent for another two decades, the changes should be made as soon as possible. Delay only increases the amount of benefit cuts and tax increases needed to keep the system solvent. Just as important, future beneficiaries affected by many of the proposed changes will need time to prepare, since any changes are likely to affect their retirement income in important ways.

1 The maximum level of wages is adjusted annually according to increases in the average wage index. Presently, 10.7 percent goes to the Old-Age and Survivors Insurance (OASDI) trust fund. The other 1.7 percent goes to the Disability Insurance (DI) trust fund. The combined OASDI trust funds will be treated as a single entity since they are administered together and money is often switched back and forth between the funds, depending upon their relative needs. An additional payroll tax of the 2.9 percent of all wages goes to fund the Hospital Insurance (HI) portion of Medicare. Thus, for 1998 the total tax assessed by the Federal Insurance Contributions Act (FICA) will be 15.3 percent of all wages up to $68,400 and 2.9 percent of all wages above this amount.

2 This report uses the Social Security Administration’s intermediate forecasts. In the past, these forecasts have been overly optimistic. Nevertheless, most observers view them as the most detailed estimates available.
The next three years offer perhaps the best opportunity to deal with the coming problems. Even Social Security’s strongest proponents admit that some changes are necessary, although they deny that it is facing a crisis. Most important, public acceptance of the need for change is growing. Large numbers of young people do not expect to receive anything from Social Security and Medicare. They may be willing to accept lower promised benefits if reforms make it easier for them to exclude a significant portion of their own earnings from taxation, provided they are invested in a savings plan. Older Americans are increasingly worried about whether the safety net will protect them when they retire. Reforms that increase the probability of Social Security lasting through their retirement, even at a reduced level of benefits, can reassure them of a basic level of benefits while increasing their ability to accumulate their own savings. Any major reform will face significant political and transitional problems, however.

The first section of this report looks at the demographic problem facing Social Security. The next section reviews Social Security’s history and accomplishments. The third section reviews the problems Social Security has in meeting either of its two main policy goals. Finally, the report discusses some of the problems associated with existing proposals for reform, and suggests a direction in which future changes should aim.

Does Social Security Face a Crisis?

The debate over Social Security involves both the nature and the extent of changes needed to improve the program’s financing. The extent of changes recommended depends in turn on whether or not one thinks that Social Security is facing a crisis. Groups that advocate only marginal changes to existing law deny that there is any crisis to be solved. Although they agree that it is better to act now in order to reduce the amount of change needed and to give people time to plan, they contend that the idea of a universal system funded by taxing the wages of one generation to pay for the retirement of another remains sound.

Proponents of extensive structural change tend to believe that the program’s financing is inherently unstable and will eventually collapse. While they admit that marginal changes can once again delay the date of insolvency, they maintain that collapse will eventually come, perhaps 50 or 75 years hence. The only way to prevent insolvency is to restructure Social Security so that its financing is stable on a permanent basis. The sooner this is done, the easier the transition will be.

This report argues that demographic trends will place increasing strain on the government’s retirement programs during the next 100 years. In the past, this problem has been solved by periodically raising the payroll tax rate or reducing benefits slightly. Another round of such changes may be sufficient to delay the crisis for a few more decades, but eventually either payroll taxes will have to be raised impossibly high or the retirement programs will have to cut benefits severely, transforming them into radically different programs than they are now.

There is another, more fundamental problem with most reform proposals. Almost every reform seeks to balance Social Security over the long-term by running large surpluses now and then using those surpluses to fund later deficits. These surpluses are currently invested in federal bonds, and the government uses the revenues to fund other programs. But if the surpluses are spent on programs that provide benefits to individuals, as they are now, then the federal government is unlikely to have the reserves needed to avoid large deficits when it has to repay the bonds. More importantly, even if the government had the resources needed to pay for large Social Security deficits, political pressures would grow to devote some of the funds to other public priorities. Unless current reforms ensure that Social Security never runs large annual deficits, beneficiaries will always be vulnerable to the possibility that a future Congress will cut Social Security benefits to fund other spending priorities, such as education, health care for working families and children, or other social services.

The status of the Social Security trust fund is worth examining in detail because the program’s defenders place a large amount of faith in the promise that current surpluses will be available to pay for benefits when the program begins running annual deficits. There are major problems with the concept of a federal trust fund. First, unlike a private pension fund where contributions are invested in productive assets, Social Security surpluses are invested in Treasury bonds and the proceeds are spent on other

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3 Last year Congress’s attention was focused on balancing the budget and educating the public about the need for change, as well as on addressing the finances of Medicare, which is in even greater financial difficulty. With Congressional elections in 1998, leaders will probably defer any final legislation to 1999. If legislation is not enacted then, the political pressures surrounding the national elections make it unlikely that major legislation affecting Social Security will be passed in 2000, postponing any changes until 2001.
programs. Once Social Security begins running deficits rather than surpluses, the government will have to begin cashing in its bonds. This will require it to do one of three things: (1) raise taxes, (2) cut spending on Social Security or other programs, or (3) run large deficits and finance them by issuing new bonds to the public. The program's supporters never identify which of these options the government should pursue. In all likelihood, the government will perform a combination of them, and part of that combination is likely to include cutting Social Security payments.

Social Security’s financing would be much sounder if the government was investing in some outside store of wealth such as the private stock market. The value of this fund would grow over time and, when Social Security began running deficits, tangible assets could be sold without affecting other government finances. But even in this case, there is no assurance that future Congresses would devote all of the money to Social Security as promised. If in 30 years, government holdings were generating annual income of several hundred billion dollars, it seems very likely that political demands would grow to spend some of this money on other programs, even if this required reducing Social Security benefits.

Until recently, Social Security has been protected from budgetary pressures because it is running annual surpluses of roughly $30 billion. But even though these surpluses are likely to continue for the next 15 years, pressures are already growing for reform. How much stronger will the pressure be when the payroll taxes are falling short of program benefits by tens or hundreds of billions of dollars? It is not at all certain that current surpluses will be sufficient to protect Social Security from the political effects of future deficits.

Although almost all reform plans claim to balance Social Security over the next 75 years, most run large deficits during the last decades of this time period. If these deficits lead to pressure to reduce benefits further, then it is misleading to say that the reforms have solved the problem for the full period. Plans that do not maintain a rough balance between Social Security’s income and outlays on an annual basis should be viewed with some suspicion.

The demographic problem facing Social Security makes it unlikely that future workers will be willing to pay the full cost of Baby Boomers’ retirement. This makes it imperative that future retirees begin saving more now. If Social Security cannot protect retirees from the political pressures they will face when it comes time to cash in current savings, then a more secure vehicle of savings must be found.

### The Demographic Problems Facing Social Security

In the 1930s when Social Security was first created, public trust in the power of government was extremely high. This faith in the ability of government programs to sensibly redistribute wealth on a grand scale continued through the 1970s, allowing periodic increases in the program's size and scope. The popular belief in continued government-managed prosperity was so strong that future Nobel laureate Paul Samuelson could boast:

The beauty about social insurance is that it is actuarially unsound. Everyone who reaches retirement age is given benefit privileges that far exceed anything he has paid in. And exceed his payments by more than ten times (or five times counting in employer payments)! (italics in original).  

* * *

So long as prices, real income, and population continue to grow at a compound rate of interest, each newly retired group can be paid benefits far exceeding what a private voluntary insurance actuary could ever pay. Today's young get cheated only in the remote political event that tomorrow's more numerous young could opt out of the system. (italics in original)  

This optimism was explicitly based on stability in three areas: real income growth, prices, and population. In the 1970s stagflation eroded the first two assumptions, requiring significant reform of Social Security in 1977 and again in 1983. Future rates of economic growth and inflation look more promising, although economic growth is not expected to return to the levels that were common when Samuelson made his statement.

The more immediate problem for the future concerns the third assumption: continued population growth. The demographic problem facing retirement programs consists of two parts: increased longevity and the retirement of the Baby Boomers early in the next century. The fundamental problem with current federal retirement programs is that they do not require individuals to save for their own

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5 “Paul A. Samuelson on Keeping the Score,” *Newsweek*, May 1, 1967, p. 80.
retirement. Instead, they require each generation to pay for the retirement of the generations preceding it. In 1940 when less than 7 percent of the population was over 65, this had strong political benefits. The government could generate political support for the new program by immediately enrolling these individuals as beneficiaries even though they had paid little or nothing into the system. At the same time, because the proportion of elderly was so small, payroll taxes could be held low. Workers were generally willing to pay these low taxes in exchange for the promise of future benefits.

This means of financing might work if the proportion of workers to beneficiaries remains stable over time. Instead, the proportion has fallen steadily over time, a trend that will accelerate in the future. The average life expectancy for a male born in 1940 (and retiring in 2005) was 61.4 years. Also in 1940, 65-year old males could expect to live only 11.9 more years. Males born today can expect to live 72.8 years and a man turning 65 today will collect benefits for another 15.6 years. These improvements in life expectancy mean both that more people reach the age where they can begin collecting benefits and that they collect benefits for a longer period of time.

In addition to the long-run trend of increased longevity, there is a cyclical problem created by the demographic effect of the so-called Baby Boomers. Beginning around 1940, birth rates increased dramatically and stayed high until around 1964. This cohort of individuals, known collectively as the Baby Boomers, at first created a surge in the demand for child-care products and education and then strongly increased the size of the nation’s workforce. Beginning when the first Baby Boomers reach 65 in 2010, they will create a similar surge in the number of beneficiaries in the nation’s retirement programs. After 1960, however, birth rates began to decline, meaning that behind the Baby Boomers is a much smaller generation of workers to pay for these benefits.

Chart 1 shows past and projected ratios of covered workers to OASI beneficiaries. This ratio has already fallen from 16.5 in 1950 to 3.3 today. By 2030, it is expected to be as low as 2.4. With only 2.4 workers available to pay for the benefits of each retiree, average benefit levels will have to fall or tax rates will have to increase dramatically, unless substantial savings are set aside while these retirees are still working.

![Chart 1: Ratio of Covered Workers to OASI Beneficiaries (1945-2075)](chart)


Until 1983, funding problems were solved largely by periodic tax increases (Chart 2). Even though the ratio of covered workers to beneficiaries has remained roughly constant since 1965, OASDI payroll taxes still increased by 5 percentage points in order to keep the program solvent. The current high tax rates and political opposition to raising new revenues make future rate increases difficult, however.

Opponents of structural change claim that the ratio of workers to retirees is unimportant. Instead, they point to the ratio of workers to dependents, which includes children under 18. Because birth rates are expected to remain low, the total burden on the worker will not increase as dramatically as will the ratio of retirees to workers. It is far from certain that low birth rates will continue, however. Fertility actually increased during the 1990s and may remain at current levels or even continue to increase.

But even if the total burden of the dependent population remained constant, the concern over high payroll taxes is not just whether future workers will be able to pay them but also whether they are willing to pay them. If they are not, then current
workers will not receive the benefits promised to them. The fact that workers often make large sacrifices to support those closely related to them, including children, does not mean they will make similar sacrifices to support unrelated individuals. Whether or not the total burden increases, it is unlikely that future workers will be willing to pay substantially higher payroll taxes in order to support the retirement of people they do not even know. This means that benefits will have to be cut.

Chart 2
OASDI Payroll Tax Rates and Taxable Payroll (1937-1998)


Even if total income transfers remain constant, an important distinction exists between investment and consumption. Expenditures on the young such as education and health care, if properly done, represent investments in the future since today's children will be tomorrow's workers. On the other hand, transfer payments to the elderly, while they may be fully justified ethically if given to individuals with low income, represent consumption rather than investment and do little to raise national income.

This distinction is important because, although the demographic increase in retirees cannot be avoided, the nation's ability to deal with it will be significantly improved if the economy experiences higher economic growth over the next three decades. If the government were to concentrate on providing everyone with the incentive and opportunity to save during their working years, the proportion of elderly who need further assistance in old age would gradually decline. At the same time, these policies would increase national savings, making it easier to fund the investments that could boost long-run economic growth.

There is a final reason why attempts to diminish the relevance of declining worker-to-beneficiaries ratios miss the point. On a national level, support of both the elderly and the young are unavoidable, and must come either out of the income of current workers or out of the surplus wealth saved up by earlier workers. But the source of spending matters. During the 1950s and 1960s, support of the Baby Boomers came largely from their own families and from local investments in education. Social Security, however, is premised on a large federal role with little leeway for individual choice. Workers are likely to show greater resistance to rising support payments that come in the form of higher federal taxes when they cannot attach a name or a face to the beneficiaries of their sacrifice.

Chart 3
Projected Annual Balance for OASDI Trust Fund Excluding Interest (1995-2070)


The aging of the American population will place an increasing strain on workers. It is important to remember that this strain accelerates dramatically after 2010 when the first Baby Boomers reach 65. Social Security remains in relatively good shape until then. But as soon as the first of the Baby Boomers switch from paying payroll taxes to collecting benefits, the situation turns sharply negative. As the mass of Baby Boomers begins to approach retirement around 2030 and 2040, Social Security's balance rapidly worsens and continues to get worse for the next several decades.

Chart 3 shows the annual balances forecast by the Board of Trustees. For the next 15 years, the
program continues to run annual surpluses averaging $30 billion to $35 billion. In the past these surpluses have largely insulated Social Security from the type of cuts suffered by the government’s other major entitlement programs, Medicare and Medicaid. Beginning in 2012, the program begins running deficits, however. In 2015 the annual deficit is $65 billion. Within 10 years the yearly deficit climbs to $425 billion. The program’s strongest supporters point out that Social Security’s trust fund theoretically will cover its shortfalls until 2029, a year in which its annual deficit is over $500 billion. This assumes that the government will make annual interest payments of several hundred billion dollars to continue funding the program. It is unlikely that the government will tolerate deficits of this size, especially if other national needs are going unmet. Within the lifetime of today’s workers, current estimates actually forecast annual deficits in the trillions of dollars. Well before then, Social Security would become politically unsustainable.

Table 1
Expected Date of Insolvency of the OASDI Trust Fund 1983-1997

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Source: Annual Reports of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.

Even these estimates may be optimistic. Table 1 shows that government forecasts of the date of insolvency have steadily moved forward ever since the last major restructuring of Social Security in 1983. Although the current forecast has remained steady for the past four years, the pattern indicates that a sudden worsening should not come as a complete surprise. Indeed, a recent panel of experts found that Social Security’s projections of future life expectancy are too conservative since they assume that the annual progress in reducing death rates over the next 20 years will fall to half of that experienced by men and just over one-third of that experienced by women during the 1968-88 period.

If current progress on reducing death rates continues, Social Security’s long-run actuarial deficit would worsen by over 30 percent.

Social Security and Medicare
Although this report focuses on Social Security, any solution must take into account the changes needed to reform Medicare, the government’s other major retirement program. These reforms will affect both the need and the ability to pay for Social Security. Part A of Medicare, the Hospital Insurance Trust Fund (HI), is funded by a payroll tax of 2.9 percent of all wage income. According to the most recent Trustees’ report, this program is already running deficits and would have been bankrupt by 2002. The recent budget agreement between the Administration and Congress contained changes that put this date off until 2007 and created yet another commission to recommend the deeper reforms needed to deal with the Baby Boomers. It is difficult to see how these changes can avoid fundamentally altering this part of Medicare since, at the beginning of the year, the current long-range deficit was projected at 4.32 percent of taxable payroll, almost twice that of Social Security.

Part B of Medicare covers Supplementary Medical Insurance (SMI). Beneficiaries pay premiums which cover approximately 25 percent of the cost of this portion of Medicare. General tax revenues fund the rest. A large part of the “savings” recently enacted to extend the bankruptcy date of Part A by six years comes from transferring the fastest growing program, home health care, to Part B. Although premiums will rise to cover part of this additional cost, most of these funds will come from taxes. The transfer, by itself, does not save taxpayers money. It merely switches the source of funding from payroll taxes to general taxes and premiums.

The expected cost of Medicare is even more dramatic when measured as a percentage of GDP. Chart 4 shows projected growth for both Part A and Part B over the next 75 years before taking into

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account the changes contained in the budget agreement. Notice that the lines continue increasing past 2070, indicating that the problem only continues to grow.

![Chart 4](Projected Medicare Costs as a Percent of GDP (1995-2070))

Although the last Trustees’ report does not reflect the most recent reforms, the problems facing Part A alone remain at least as serious as those faced by Social Security. In 2010, the deficit for Part A was forecast to be $156 billion. By 2030, the deficits have grown to $1.1 trillion and the problem continues to get worse. Dealing with the fiscal problems facing both Part A and Part B of Medicare, as well as long-term nursing home costs paid for by Medicaid, will leave fewer resources for Social Security.

The Goals of Social Security

Any program that spends over $300 billion per year, as Social Security now does, inevitably helps a large number of people. But the fact that many people have become dependent on a program is not necessarily a sign of success. Design flaws in the original concept of Social Security limit the amount of good it can do. From its inception, the program has tried to accomplish two distinct and often conflicting goals: (1) to redistribute income so that even the poorest elderly would have a minimum standard of living; and (2) to act as a mandatory savings program ensuring that each worker saved for his retirement. It is inevitable that improvements toward one goal will often conflict with the other. With enough money, however, both can be met satisfactorily. Thus, when the number of beneficiaries was small, even a low level of payroll taxes brought in enough revenues to meet both goals. Increasingly, however, pursuit of both goals requires perpetually higher payroll taxes, a solution that in the long run jeopardizes both. Given the demographic trends discussed above, the program will have an increasingly difficult time meeting either goal. Rather than fail at both, it would be better to concentrate on one while developing alternative policies to address the other. If it continues to pursue both goals, Social Security will soon approach the time when it creates more harm than it does good.

Social Security as a Poverty Program

The fundamental purpose of Social Security was, and to many still is, to prevent destitution among the elderly.\(^{10}\) The program is widely credited with reducing the proportion of elderly living in poverty. As recently as 1970, 24.6 percent of all individuals over 65 had incomes below the poverty line. In 1994 the comparable figure was 11.7 percent. This compares to 21.2 percent of all children.\(^{11}\) Social Security can be credited with much of this decline since it provides income directly to those over 65. In fact, 45 percent of all senior citizens living alone rely on it for at least three-fourths of their income.\(^{12}\) The reduction in elderly poverty is Social Security’s greatest accomplishment, and any modification or replacement of the program should ensure that these gains are not reversed.

Social Security suffers from several problems as a means of redistribution, however. Perhaps most seriously, even with the addition of Supplementary Security Income (SSI), over one-tenth of all elderly continue to live below the poverty line. The program could provide additional income to those elderly who need it most if less was given to those who are well off. But any prospective form of means-testing would reduce the incentive of current workers to save for their own income, jeopardizing Social Security’s other goal.

As a redistribution program Social Security suffers on both the income and expenditure sides. On the expenditure side, 15 percent of the elderly poor

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living alone receive no Social Security benefits.¹³ Unlike most redistribution plans, Social Security benefits are positively related to income. As a result, approximately $6 billion goes to households with over $110,000 in income.¹⁴ Although these benefits are now subject to partial taxation, beneficiaries in the highest income tax bracket still keep two-thirds of their benefits. The standard justification for this is that it would be unfair to deny even the affluent elderly benefits since they have paid into the program. But if Social Security is primarily intended as a redistribution program, then payments into it should be viewed as taxes rather than payments into a savings program. Government normally does not promise workers a return on their income taxes. Instead, it devotes the revenues to the most pressing national needs.

Another rationale for universal benefits comes from the fear that devoting more resources to eliminating poverty among the elderly will reduce the program’s political support among the middle class. According to this view, Social Security can retain its popularity only by spreading its benefits broadly. In the words of Wilbur Cohen, a former Secretary of Health, Education, and Welfare:

[...] a program that is only for the poor—one that has nothing in it for the middle income and the upper income—is, in the long run, a program the American public won’t support. This is why I think one must try to find a way to link the interests of all classes in these programs.¹⁵

Although wealthier recipients tend to receive higher benefits, the opposite is true when it comes to payroll taxes. Social Security collects 12.4 percent of even the poorest worker’s wages. Younger workers do receive disability insurance, and the 1.7 percent of payroll allocated to this program is roughly equal to what they would have to pay for similar coverage in a private market. Still, if we add in Medicare, workers are paying 13.5 percent of their salary into programs that promise them very little unless and until they reach retirement age.¹⁶ This tax rate drops dramatically at higher levels of income. Although the 2.9 percent Medicare tax applies to all wage income, the 12.4 percent OASDI tax ends completely at income levels above $68,400. Finally, FICA taxes apply only to wage earnings. Since wealthier people are likely to have higher proportions of nonwage income, such as capital appreciation and interest earnings, Social Security tax as a percent of total income becomes regressive.

A more disturbing trend is the number of children living in poverty. In 1970, 14.9 percent of all children lived in poverty. By 1982 this figure had risen to over 21 percent and has remained close to that level since then.¹⁷ Although Social Security is not directly responsible for this trend, it does claim a large proportion of federal outlays that might otherwise be devoted to this problem. It also is clear that current living standards of young families would be significantly increased if their parents were not required to pay large FICA taxes.¹⁸

Social Security’s defenders often seem oblivious to the program’s effect on the living standards of workers. As one supporter recently said in arguing for increases in the payroll tax:

... [E]ven if real incomes do not rise, do Americans have to be so unaltruistic? Do they have to be so concerned with constantly rising incomes, and have five cars in every garage, and three television sets in every room? We have a very high standard of living in this country for most people. Something ought to be done with regard to those whose living standard is inadequate. But the majority ought to be satisfied with what they have, or at least with smaller increases than would occur if they did not consider the needs of others.¹⁹

These sentiments would be valid if the rich were the only ones who paid Social Security taxes and the poor were the only ones who benefited. But they apply neither to the payroll taxes paid by

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¹⁶ Technically half of this amount is paid by the employer and only half is paid directly by the employee. Most studies agree that over the medium term, employers are able to pass almost all of this tax on to workers through lower wage increases or reduced benefits. See, Steuerle and Bakija, *op.cit.*, p. 74.


¹⁸ The current Administration justified extending the recently-passed $500 child credit to low-income families on the basis that the credit would offset the FICA taxes these families pay. This argument implicitly acknowledges that there is little economic or policy difference between payroll taxes and regular income taxes.

those currently living in poverty nor to the benefits going to those earning high incomes.

Several aspects of Social Security raise serious policy problems. First, it is not clear why the nation's largest income support program is limited largely to individuals over the age of 65, especially when poverty rates for this group are below the national average. Second, Social Security currently does not guarantee even the poorest retirees a minimum standard of living. Supplemental Security Income, which is primarily directed at retirees and handicapped persons, did guarantee an income of $5,640 for individual recipients in 1996, but it is funded from general revenues rather than from payroll taxes.

Social Security tries to favor the poor by ensuring that benefits replace a smaller proportion of wages as income increases. Thus low-wage workers receive benefits replacing as much as 85 percent of their average earnings, while higher-income individuals receive a much lower replacement ratio, even though their total dollar benefits are higher. This method of redistribution is highly imperfect. For past generations, although higher income individuals received a lower rate of return, they received a larger amount of net benefits. As a result, the treatment of past retirees was actually regressive, increasing the income gap between workers of the same generation.

One study of Social Security estimated that the net present value of Social Security for individuals born in 1925 (who turned 65 in 1990) was $94,638 for a one-earner couple with low earnings, a real internal rate of return of 6.83 percent. A similar couple with a high earner received net benefits of $158,458, however, even though the rate of return was only 5.24 percent. The effect is even more dramatic if one considers the fact that the poorer couple was more likely to have two earners, and thus pay tax on two salaries. In this case the net benefits fell to $75,238, and the rate of return fell to 4.78, below that of the high-earner.

It is true that these imbalances decrease somewhat in later years. For those born after 1940 (who turn 65 after 2005), high earners always receive less out of the system than they pay in, except in the case of a one-earner couple. And low-earners generally receive higher benefits than either average- or high-earners, again except for the case of a one-earner couple. But by then the value of expected benefits is extremely low, given the amount of taxes paid in. Low-income, two-earner couples receive a real internal rate of return of less than 3 percent on their payroll taxes.

Even within younger generations, Social Security may benefit the well-off more than the poor. Individuals must reach retirement before they receive any benefits at all. Yet lower-income individuals typically have lower life expectancies, making them less likely to enjoy benefits. Differential mortality rates may have a significant impact on the distributional nature of Social Security. The extent to which this reduces the redistributive aspects of Social Security has not been well studied, however.

Finally, even if Social Security did a good job of redistributing income within a generation, it does a poor job between generations. Low-income workers currently pay over 10 percent of their salary into the OASI fund, while wealthy retirees have received high rates of return and large net transfers of income. In general, Social Security taxes younger workers heavily without much regard for income, in order to give income to the elderly, again without much regard for income. As Milton Friedman wrote over 30 years ago:

Few of those who support the present system would favor either the structure of taxes by itself—a flat percentage tax on the first [68,400]

20 Annual Statistical Supplement, op. cit., p. 94.
21 An example will illustrate. If a low-income person paid $1,000 into Social Security but received $2,000 in benefits, his rate of return would be 100 percent. If a higher-income person was required to contribute $2,000 but received benefits equal to $3,500, his rate of return would be lower, only 75 percent. But the wealthier person still receives a greater amount of net benefits from the government, $1,500 as opposed to $1,000. The redistributive consequences are mitigated if the rate of return is less than the individual could have received in the private markets.
22 Steuerle and Bakija, op. cit., pp. 108-113. However, Steuerle and Bakija find that the distribution of benefits within generations will become progressive for future retirees.
23 Ibid., pp. 287, 290.
of earnings and a zero tax on higher earnings—or the structure of benefits by itself—indiscriminate benefits based on age, sex, marital status and previous employment, with no attention to need.  

The argument that any serious reform of Social Security would reverse the gains made in reducing poverty is a weak one. Irrespective of how Social Security is reformed, the federal government should help individuals move out of poverty. While it is difficult to design a program that preserves individual incentives to do as much as possible on one’s own, certain aspects of such a program seem obvious. To begin with, it should be financed out of general revenues where the current progressive nature of income taxes ensures that payments come from those that can afford them and go to those who need them. And it should cover poor people of all ages. A poverty program funded by high payroll taxes on the poor, that pays benefits according to age and not income, is likely to worsen the very problem it tries to solve.

Social Security as a Retirement Program

Social Security also acts as a forced retirement savings program. Once the government accepted the obligation of guaranteeing a minimum living to every retiree, policymakers began to worry that individuals would lack the incentive to save on their own. Social Security was never intended to be a retiree’s only source of income. In a widely used metaphor, it was supposed to be the third leg of a stool, with the other two legs being employer-provided pensions and personal savings. Yet each of these ultimately relies on the same source of funding: the difference between what a current worker earns and what he consumes. As a result, efforts to increase the size of one source of retirement income are likely to make it harder to maintain other sources. Specifically, the 15.3 percent of personal wages currently devoted to Social Security and Medicare reduces the ability of workers to save on their own.

From the start, however, Social Security never operated as a true retirement savings plan. Unlike a normal savings program, benefits are not linked to payments into the program. Rather than requiring everyone to save for his own retirement, each generation of workers pays for the retirement of older generations in exchange for the promise that they will be taken care of by the next generation. In the program’s first decades, the low ratio of retirees to workers allowed retirees to receive benefits even though they had put little or nothing into the system and allowed the government to keep tax rates low. But tax increases are inevitable once the ratio of workers to retirees begins to fall. Since the higher taxes do not lead to higher benefits, workers receive a lower rate of return on their participation. Eventually, the point is reached where the majority of workers would be better off investing their payroll taxes in a personal savings account such as an Individual Retirement Account or a 401(k) plan.

Employer-sponsored pension plans and individual savings are also major components of the nation’s retirement system. When Social Security began, employer-provided pensions were relatively rare and individuals of modest means had few investment vehicles other than a bank savings account or individual stocks. Transaction costs made it difficult to create a well-diversified portfolio. This understandably raised the profile of the Social Security leg of the stool. Now employer-provided plans are more prevalent. More importantly, individuals have a far greater ability to invest on their own through mutual funds.

Yet even as the choices available to them have grown, their ability to save has been reduced. When tax rates were low, it was reasonable to expect workers to save a substantial portion of their wages for retirement. But as payroll taxes increased, workers had a lower portion of their income from which to save.

The growth of Social Security has coincided with a decline in the national savings rate. The reason for this decline is not well understood, and there are many areas of uncertainty regarding which age groups have reduced their savings, the role government has played in the reduction, and what can be done to reverse the trend. It seems reasonable to believe, however, that the promise of large benefit payments in relation to what was paid into the system caused past workers to save less on their own, while high tax rates are reducing the ability of current workers to supplement Social Security. Although earlier theories attributed much of the decline in national savings to the Baby Boomers, more recent studies attribute much of the decline to their parents, who have reaped the largest rates of return on their Social Security payments.

Ultimately any savings must come out of the difference between workers’ total productivity and their consumption. The fact that half of the payroll tax is paid by employers or that employers may sponsor pension plans does little to change the fact that all savings must eventually come out of workers’

income. If workers are paying high FICA taxes, they have less income to fund pension programs or to start their own savings accounts.

Universal participation makes sense if the purpose of Social Security is to act as a forced savings plan rather than to redistribute income. In this case, however, its effectiveness should be compared to private savings plans. One of the primary criteria for measuring any savings program is the rate of return it promises to the average worker. It may be understandable that a mandatory, government-run program offers a lower rate of return to higher-income workers in order to redistribute income. But offering low rates of return to all workers, including those with average and low incomes, would be hard to justify.

The failure to invest Social Security taxes has caused rates of return to fall to extremely low levels. Chart 5 shows that earlier generations reaped large returns from the program, contributing to its popularity. These returns were possible because early tax rates were low and the ratio between workers and retirees was high. In the future, however, rates of return will continue to fall until they finally even out at relatively low rates of return. Chart 5 shows rates for average wage-earners in each category. Returns are not appreciably different for low-wage earners.

**Chart 5**

**Implicit Rates of Return on OASI Taxes to Different Generations (1950-2050)**

![Chart](image)


Even the rates of return shown in Chart 5 are inflated. The calculations assume that current law remains unchanged, that benefits are not cut, and taxes are not raised. But everyone acknowledges that some changes will have to occur. While it is uncertain who will bear the burden of these changes, they are likely to lower the real level of net benefits to all future retirees. The result is that Social Security promises young workers much less than they could get if they invested their OASI taxes in a well-diversified portfolio over the course of their career. Not only is this true of wealthier individuals, who might be expected to bear the financial burden of redistribution, it is true even of the poorest worker.

Chart 6 shows the real rates of return that individuals would have received from investing in the Standard & Poor’s 500, something that is now relatively easy to do through a large number of mutual funds. Using data supplied by Ibbotson Associates, the chart shows the average internal rate of return for both 30-year and 40-year periods, beginning in 1926, before the Great Depression. Although the rates vary over time, they always remain well above the returns available from Social Security.

**Chart 6**

**Historic Real Rates of Return on the S&P 500 (1926-1993)**

<table>
<thead>
<tr>
<th>Rate of Return</th>
<th>Year Cohort Turns 66</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-year Average</td>
<td>2050</td>
</tr>
<tr>
<td>40-year Average</td>
<td>2040</td>
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A major criticism of allowing private accounts is that individual investors cannot bear the risk of a market crash. Therefore, Chart 6 also shows the cumulative rate an investor would have received had he begun investing in 1929, right before the market crashed. Within 15 years, the individual is...
receiving rates of return above that promised by Social Security. This period is approximately equal to the life expectancy of someone retiring today. More relevant is the bold line showing the 40-year return assuming that the market fell by 50 percent the day before the investor sold his stock. Returns are still well above those promised by Social Security. Fear of a market downturn similar to that of the Great Depression is especially overdone when one remembers that such an event would dry up tax revenues, forcing reductions in social programs such as Social Security and Medicare. Moreover, the rapid increase in insurance products such as fixed and variable annuities, makes it possible for even the most risk-averse investor to ensure relatively high rates of return.

Rates of return will differ from investor to investor, but experience shows that in a well-diversified portfolio invested over the long-term, it is virtually impossible for any individual to do worse than the rate of return promised by Social Security. Once again, this is true not just of the wealthy, who might reasonably be asked to suffer lower returns in order to redistribute income, but also of the poor.

**Fixing Social Security**

We have seen that, although Social Security is an important source of income to many low-income elderly, it is difficult to say whether or not it alleviates more poverty than would be the case if everyone participated in some form of private retirement plan. The program mainly redistributes income between generations rather than between income groups as a normal poverty program would.

Social Security also fails as an individual savings program. Although early generations earned high rates of return on the payments they made into the system, these rates have already fallen sharply and are likely to turn negative. No private-sector savings program could survive if it promised investors such a low rate of return, even on a risk-adjusted basis.

Why then has the current program garnered so much support, and why are its defenders so quick to denounce reforms as an attack on the poor? The argument has always been that Social Security must be viewed in its entirety; attention should not be paid to who is actually getting benefits or paying taxes now, but on the communal aspect of the government's commitment to all workers.

Social Security's shortcomings as both an anti-poverty plan and a retirement savings plan seem beside the point to its most vocal supporters. What matters to them is that, for good or evil, the program puts almost all Americans in the same boat. Like the public school system and the national

...[A]ll Americans have an obligation to participate, since an effective Social Security program helps to reduce public costs for relief and assistance, which, in turn, means lower general taxes. 26

This statement does not explain the wisdom of requiring low- and middle-income workers to participate in a program that promises them far less than they would get in the private markets. Nor is it clear that Social Security raises national savings. In fact, the promise of Social Security and Medicare benefits may cause people to save less in their personal accounts. Individual savings depends in part on whether government tax policy encourages such savings. Allowing every worker to place 10 to 15 percent of his pre-tax salary into an Individual Retirement Account and delaying taxation on earnings in the account until they are withdrawn, would provide workers with a strong incentive to save. If low savings rates are really a concern, contributions to such an account could be made mandatory. If the goal is to reduce poverty, one could easily fund a compulsory anti-poverty program through general tax revenues without attaching to it a universal forced savings program.

The universal nature of Social Security is not needed in order to reduce poverty. Rather, it stems from a strong desire for communalism and a fear that, if every worker is allowed to plan his own

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future, a minority will be left behind. Social Security’s strongest proponents on the Advisory Commission argue that:

Social Security is a blend of reward for individual effort and, at the same time, perhaps our strongest expression of community solidarity. Social Security is based on the premise that we’re all in this together, with everyone sharing responsibility not only for contributing to their own and their family’s security but also to the security of everyone else, present and future. (emphasis in original).

They fear that plans that partially privatize Social Security will drive a wedge between high- and low-income earners as the former press for still greater privatization since:

... there would be every reason for many average and above-average earners, particularly, to press for further reductions in contributions to Social Security in order to make more available for their individual accounts. Thus, the IA plan [which allows for individual accounts] is inherently unstable, and could lead to the unraveling of the redistributional provisions that are so integral to Social Security and so crucial to its effectiveness.

But we have seen that Social Security is already unstable. Its supporters are right that income redistribution is an important policy goal. But the need for redistribution is not limited to senior citizens. This goal should be addressed up front, not hidden behind elaborate savings or health programs (such as Medicare), and should be linked to reciprocal obligations on the part of recipients. Redistribution should be funded through the income tax, ensuring that the well-off bear most of its burden.

Should Individual Accounts Be Allowed?

Almost all reform plans now call for investing more of the money currently going to Social Security into the stock market. A decade ago such proposals would have been unthinkable. Given the program’s current problems, they are inevitable. The reason is that real returns in the stock market have consistently been higher than those credited to Social Security’s investment in government bonds. Even some of Social Security’s staunchest supporters have been forced to rely on these higher rates of return in order to minimize the benefit cuts and tax increases needed to achieve long run solvency in the trust fund.

But the method in which this is done varies dramatically. The least reform-minded plans would maintain Social Security as one large, undifferentiated fund from which all benefits are paid. The government would invest in a representative index of companies. Under the Maintenance of Benefits (MB) proposal supported by six members of the Advisory Council, the government would be little more than a holding company, passively duplicating the chosen market index and not participating in shareholder decisions. Its supporters argue that political pressures to maintain high returns would prevent the government from using its powers to influence company management.

But the risks of a mandatory government-run fund are great. There would be continuous pressures within Congress and by powerful interest groups to exclude from the investment fund the shares and bonds of companies that pursue political, social, and environmental policies which they disagree with. Several state and local government funds are currently considering using their pension investments to pursue political objectives such as improving human rights in Burma and forcing Switzerland to return Jewish bank accounts seized during World War II. Labor unions are pressuring pension plans to consider a company’s labor relations when investing. Surely pressure would exist to have the federal government join these efforts. It is not clear that the political pressure to avoid meddling will be equally as great. Since there will be no individual accounts and since benefits will depend on a statutory formula rather than on actual returns, beneficiaries may lack an incentive to resist pressure from social activists.

Just as important, the government’s presence would have a large effect on the market. Being included in the relevant index of funds would entitle a company to the investment of Social Security funds, almost irrespective of performance. And, under the MB proposal, the trustees could do little to pressure corporate boards for better returns by voting the fund’s stock. Thus a company would have a significant portion of its stock effectively isolated from any attempt by outsiders to purchase the company. On the other hand, a company that was suddenly dropped from the index would suffer

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29 Ibid., p. 89.
30 Ibid., p. 62.
a divestment of government funds, severely depressing its stock price and possibly leading to economic losses.

Opponents of individual accounts voice two main arguments. One is the need for community and common fortunes described above. But given current payroll tax rates and the political opposition to raising revenues, it is hard to see how individuals can be encouraged to save more unless they are allowed to benefit directly from their savings.

Perhaps the strongest argument voiced by the opponents of private accounts are the high fees associated with private investment managers, including mutual funds. But it is unfair to look only at the fees charged by mutual funds, while ignoring their benefits. There is nothing bad about a fund charging higher fees if those fees allow it to achieve even higher market rates of return by identifying the most successful companies. While management fees differ widely, many index funds charge fees of less than 1 percent. The best way to reduce these fees is to encourage competition for an investor's funds and to educate individuals on fund fees and performance. In order to put additional downward pressure on management costs, the government could give workers the option of investing in one or more government-sponsored funds such as the Thrift Savings Plan currently available to federal workers.

The higher rates of return available in the stock market require continued economic discipline, with capital flowing out of unproductive companies and into growing ones. This discipline is very difficult to achieve without competition. There is nothing inherently wrong with the government trying to provide a service better than that of the private markets. But history indicates that few monopolies achieve high performance. It is important that individuals periodically have the freedom to transfer their savings between funds, including private ones, based on performance. If a government-sponsored fund is just one of many options available to investors, any attempt to pursue social goals at the expense of profits will cause investors to leave.

Although Social Security should be privatized by giving workers individual accounts, workers should not be required to contribute more of their income into them.

Many reform proposals would use Social Security's current problems as an excuse to force workers to save more. There is a difference between allowing individuals to divert some of their current FICA taxes to an individual account and increasing their FICA taxes to fund new accounts, however. The latter effectively creates a new mandatory savings program to address a national savings problem that may or may not exist. There are strong arguments for making it easier for individuals to shelter income from taxes by saving it. But there is little merit in requiring individuals to pay still higher taxes, especially if they will be prohibited from benefiting until decades later. As one group on the Advisory Council stated:

It is not doing most workers any favor to compel them to save, above and beyond what Social Security already requires, for the exclusive purpose of retirement. Particularly in the case of moderate- to low-income workers, earners who are living from paycheck to paycheck are likely to need to spend whatever they have on food, clothing, shelter, schooling and other immediate needs.

One might say the same about the current level of FICA taxes. Unfortunately, this group feels that such arguments do not apply to FICA tax increases.

Managing the Transition

To many, the largest hurdle to moving toward some form of privatization of Social Security is the transition cost. Put simply, the current system requires working generations to pay for the retirement of the generations ahead of them. This gives the older generation an incentive to lobby for higher benefits and to resist cuts, while the younger generation faces the opposite incentives. Making each worker responsible for his or her own retirement savings would strengthen the personal incentive to save for retirement. Since it is too late to get existing retirees to save much more, at least one generation of workers will have to accept a larger burden for its own retirement while still continuing to bear the burden of existing retirees.

In reality, however, using the transition costs as an argument against reform is misleading. Since the current system is not viable, a transition will take place at some point in time. The cost of transition to some form of privatization is significant, and only increases the longer we wait to reform the system.

Several principles should guide any transition:

- First, existing retirees should be asked to bear some of the burden. Many reform proposals seek to minimize political opposition by promising that those over 55 will not have their benefits cut. Given the burden that younger workers are certain to face, this exemption is inequitable.

31 Ibid., p. 63.