

**Due:** April 14

Private Money, Safe Money?

The following paper looks back at the introduction of Social Security and lays out some of the ideas and needs behind this government funded program. After presenting some facts and figures, the focus will be shifted towards the challenges Social Security faces: funding and demographic factors. By 2018 the program will begin running a deficit, paying out more in benefits than it takes in through taxes. The resulting shortfall will be substantial and requires either a sharp increase in payroll taxes or a reduction in benefits, or some combination of both. Overall Social Security faces a long-term funding shortfall of more than \$20 trillion.<sup>1</sup> One option for the future is privatization of Social Security through a transformation from the current pay-as-you-go system to a pre-funded system. The current developments of Social Security are unstable for the 21<sup>st</sup> century and make a reformation of the system inevitable. Whether privatization is the solution remains to be seen, however, this market-based solution ranks amongst the top of the choices.

In 1940, the United States was slowly coming out of the Great Depression. People everywhere were poor, but old people were especially hard hit and had little chance of recouping what they had lost over the past decade. There was widespread pessimism about the future and, of course, anxiety about saving for the future. But people were out of luck. Not only was there no such thing as computers, the Internet and day traders, but nobody had even heard of money-market accounts, jumbo CDs, mutual funds, index funds, competitively priced stock commissions, 401(k)s or IRAs; indeed, few companies had pension plans.<sup>2</sup>

People knew that something had to be done and they believed that government was the proper agent to provide the answers and wherewithal to any problem. The idea was to nick a little off of everybody's paycheck with a payroll tax and then give that money to the impoverished elderly. Even better, to disguise this welfare program and cheer everybody up, the tax money was

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<sup>1</sup> The 2000 OASDI Trustees Report.

<sup>2</sup> Wall Street Journal (2000).

to be redistributed to anybody over the retirement age, and the in-out mechanism was to be called a Trust Fund.

On August 14, 1935, Social Security, more formally the Old Age, Survivors, and Disability Insurance program (OASDI), was signed into law by President Franklin D. Roosevelt.<sup>3</sup> As originally designed, OASDI provided three types of benefits: retirement benefits to the elderly who were no longer working, survivor benefits to the spouses and children of people who have died, and disability benefits to people who experience non-work-related illness or injury. The Medicare portion of Social Security, which provides benefits for hospital, doctor, and medical expenses, was not created until 1965.<sup>4</sup>

In the beginning, the system worked very well. Mostly because there were plenty of workers to support this scheme—41 workers for every one retiree—and the payroll tax was set at about 2% up to the first \$3,000 of earnings, allowing an average benefit of \$272.50 a year. The real rate of return for the average single male retiring in 1940, according to Gareth Davis at the Heritage Foundation, was 114% a year.<sup>5</sup>

At the same time that benefits and beneficiaries were expanding, however, life expectancy was rising—a 65-year-old American had an average life expectancy of 12½ more years; today, it is 17½ years and rising.<sup>6</sup> In 1940, there were 2.2 children per female, but by 1998 there were fewer than two children (except for the 1950s when families had an average of more than three children—an outburst that created the boomer generation).

Accordingly, the number of workers supporting each Social Security dependent has dropped like a stone. It was 41 in 1940; then fell to 16 in 1950, to 5.1 in 1960, and to 3.3 workers in 2003. In addition, 79 million “baby boomers” will begin retiring in 2008, and in about 30 years, there will be nearly twice as many older Americans as there are today. At the same time, the number of workers paying into Social Security per beneficiary will drop from 3.3 today to about 2 in 2030.<sup>7</sup>

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<sup>3</sup> Swartz, Bonello (2003).

<sup>4</sup> Social Security Online.

<sup>5</sup> Wall Street Journal (2000).

<sup>6</sup> Social Security Administration (2004).

<sup>7</sup> Social Security Administration (2004).

These demographic changes will severely strain Social Security financing and are becoming more and more political issues. Entitlement programs such as Social Security are often referred to as “uncontrollable spending” due to their mandatory character. And with the current legislature structure of revenues and benefits, the Social Security system will be unable to meet its financial obligations at some future date.

Social Security is currently taking in more money than it pays out in benefits, and the remaining money goes to the program's trust funds. There are now large “reserves” in the trust funds, but even this money is small compared to future scheduled benefit payments. In 2018 benefits owed will be more than taxes collected, and Social Security will need to begin tapping the trust funds to pay benefits. The trust funds will be exhausted in 2042. At that time, Social Security will not be able to meet all of its benefit obligations.<sup>8</sup> Therefore, it is clear that the current pay-as-you-go system needs to be reformed. Alternatives such as a pre-funded system or a completely privatization of Social Security are in discussion and evaluation.

Since 1935 a lot has changed. For starters, the notion that people need to be protected and indemnified against risk by the government has been replaced by a more energetic sense of personal responsibility.

This is pretty clear from a review of various polls on attitudes toward the government compiled by Karlyn Bowman at the American Enterprise Institute. Over the past 30 years, American opinion has changed dramatically from trust in government competence to, well, distrust.<sup>9</sup> Likewise, a majority of Americans, especially younger ones, are expressing increased self-confidence about providing for their own future retirement. Self-reliance is in, government dependency is out.

And this self-reliance is not misplaced. Sure, it's true that more than half of American households now own stock and that's cool all by itself. But a more important point is that the past 25 years of deregulation of the financial sector and the resulting unleashing of competition have generated an array of investment and savings vehicles. Now people do have 401(k) and IRA plans, mutual and index funds, money-market accounts and access to the options and futures markets. This is as much a part of the New Economy as dot-com zillionaires.

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<sup>8</sup> Social Security Administration (2004).

<sup>9</sup> Bowman (1999).

And that's why market-based reform, or privatizing Social Security, is so appealing. It is tailored to the realities of today, not those of 65 years ago. Most people are already investors—whether they are allocating funds in their company-sponsored pension plans, opening brokerage accounts to save for their kids' education or racing home after work to day-trade their mad money.

Granted, investing involves risk, but it also generates returns and, in this case, returns are doubly attractive. First, rates of return from even a conservatively diversified portfolio will out-pace returns to be had from Social Security over the long term. Second, the assets from which those returns flow are owned by the investor, not subject to political exigencies of government "ownership."

By comparison, the average rate of return to the stock market since 1926 has been 7.7 percent.<sup>10</sup> That return has held despite a major depression, several recessions, World War II, two smaller wars, and the turbulent inflation-market, but there has been no 20-year period since 1926 during which the market was a net loser. Indeed, there has never been a 20-year period in which the market performed worse than projected future returns from Social Security.<sup>11, 12</sup> Even corporate bonds have consistently outperformed Social Security, discounting the period 1941-51, when government price controls artificially reduced the return, corporate bonds have paid an average real annual return of more than 4 percent.<sup>13</sup>

However, various authors are concerned about transforming Social Security's pay-as-you-go financing into a market-based structure. Critics claim that the transition costs are prohibitive and that people would be unduly burdened because they would have to pay twice—once for their own retirement, and once for those already retired. This double expense would be so prohibitive, it is argued, as to warrant rejecting the idea of privatization even if it were meritorious on other grounds. In addition, hidden flaws of privatizing Social Security include the costs associated with purchasing equivalent life and disability coverage (or maintaining the current disability and life insurance program in the context of a 16% cut in revenue), market risk, and higher administrative costs.<sup>14</sup>

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<sup>10</sup> Gokhale, Kotlikoff et al. (1999).

<sup>11</sup> Siegel (1998).

<sup>12</sup> Of course, critics of privatization point out, correctly, that the past is no guarantee of future performance. But the critics' contention that the future performance of private capital markets will be significantly lower than past average is unpersuasive.

<sup>13</sup> Calculated from Moody's Investor Service, Moody's Industrial Manual and Moody's Bond Survey; 1920-96.

<sup>14</sup> Hill (2000).

Last, but not least, progressives should begin fighting to improve Social Security benefits. The safety net for the poorest elderly and disabled people is dropping lower and lower as means-tested programs, such as SSI, fail to keep pace with a growing economy. Under constant pressure to protect Social Security from Wall Street's wrecking ball, advocacy groups and politicians have shied away from increasing benefits for anyone. However, there is ample evidence that such improvements are needed—particularly for disabled people and older women not living with men, who are at high risk for poverty.

In conclusion, the dramatic developments in regard to Social Security demand a sustainable system for the future. There are a couple of arguments which support a private retirement system to replace Social Security: Social Security has been a failure as an anti-poverty program even though it may redistribute money from the wealthy to the poor. Because it forces the poor to annuitize<sup>15</sup> their savings, it prevents the accumulation of real wealth and prevents the poor from passing that wealth on to future generations. Moreover, Social Security has been a failure as a retirement program because it does not provide an adequate retirement income or yield the best possible return on an individual's money. Furthermore, Social Security is fundamentally unfair, with both intergenerational and intergenerational transfers. A final point is the argument that Social Security reduces the dignity of older Americans because of the dependence from government and the political process for their retirement income.<sup>16</sup>

A retirement program based on individually owned, privately invested accounts would provide higher retirement benefits and a better rate of return than Social Security. It would lift more seniors out of poverty, and, because funds are inheritable, accumulated wealth could be passed on to future generations. It would not penalize groups with short life expectancies and would eliminate the penalty on working women. And workers would own their benefits and thus be free from political risk and dependence.<sup>17</sup>

While there is disagreement whether privatizing Social Security is the best solution, projected trust fund deficits should be addressed in a timely way to allow for a gradual phasing in of the necessary changes and to provide advance notice to workers. The sooner adjustments are made the smaller and less abrupt they will have to be.

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<sup>15</sup> To convert the account balance under a deferred annuity contract into a stream of income, either for one or more lifetimes or a specific period of time.

<sup>16</sup> Tanner (2000).

<sup>17</sup> Attarian (2000).

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