EPI Issue Brief

Issue Brief #112 | Economic Policy Institute | July 1, 1996

Privatizing Social Security: The Wall Street Fix

By Dean Baker

In June, the President's Advisory Council on Social Security will issue proposals intended to ensure the long-term solvency of the Social Security trust fund. Fear and concern for the future of Social Security has become widespread. This has led some to call not just for tax increases and benefit cuts but for the actual dissolution of the system and its replacement with a system of government-mandated private savings.

But contrary to the assertions of many public officials and to the alarm of the public at large, there is a strong case to be made that Social Security is sound now and will continue to be sound indefinitely. The major threat to the system comes from the proposals to fix it. Privatization presents perhaps the most serious threat to date: it would place individuals' retirement savings at considerable risk, force the creation of huge government bureaucracies, and leech Social Security assets out of the system and into the coffers of brokerages and banks.

Social Security Works

Social Security provides retirement income to over 35 million people. It also provides disability insurance to virtually the entire working population, as well as survivor insurance for families in the event of the death of a parent or spouse. It provides these benefits in a manner that is progressive and fair: lower-income people get back a higher percentage of their earnings as Social Security benefits, but the more someone has paid in the more they get back. The system is also efficient: the cost of administering Social Security is less than 0.7% of annual benefits, compared to administrative costs at private insurance companies that are on average more than 40 times as high.

The Social Security Fund Is Sound

Social Security is not in danger of bankruptcy. According to the intermediate projection of the Trustees of the Social Security fund (the standard basis for policy projections), the fund will be able to meet all of its benefit payments to the year 2030, *with* no increase in taxes *whatsoever*. Even this projection is based on pessimistic assumptions. For example, it assumes that economic growth over the next 35 years will be far lower than during any 35-year period in U.S. history. It also assumes that wage growth will not increase, even though the trustees forecast a labor shortage created by the retirement of the baby boom generation. History and economic theory suggest that the economy will perform better than indicated by this gloomy scenario, and therefore the Social Security fund should be able to pay out all its benefits even further into the future, with no change in policy.

While the retirement of the baby boom generation will place increased demands on government budgets in coming decades, this pressure will be offset largely by the smaller segment of the population comprising children. This changing demographic mix will lead to savings in education and other govemment spending that supports children, which currently accounts for approximately 20% of all govemment spending. The dependency ratio (the ratio of both children and retirees to workers) is projected to rise gradually until 2035, but even then it will reach only 84% of its 1960 level. Since output per person should be more than 2.5 times as great in 2035, there is little reason to believe that the dependency ratio in that year will create an unsustainable burden.

Future Generations Will Enjoy Higher Living Standards

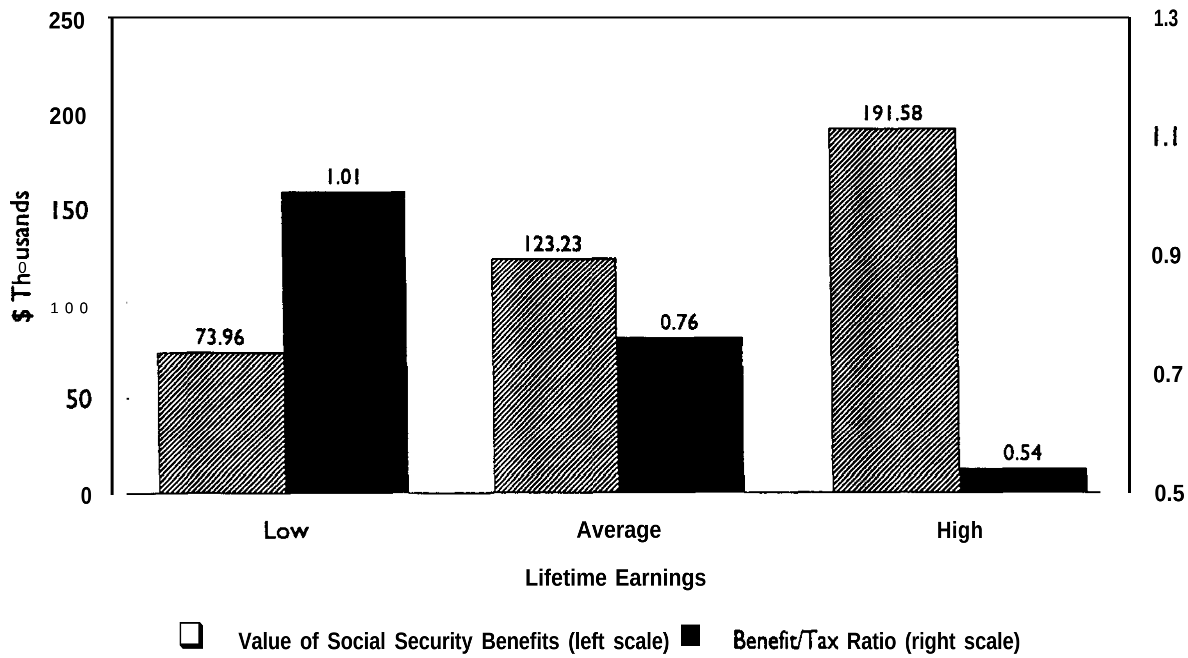
Even the pessimistic projections in the Social Security trustees' report show that wages will be on average 35% higher in 2030 than at present, after adjusting for inflation. If the consumer price index (CPI) overstates inflation, as many claim, future generations will be even better off. For example, according to the estimate of the Boskin commission (a commission appointed by the Senate Finance Committee to evaluate the accuracy of the CPI), average wages will be 140% higher in 2030 than at present and nearly 300% higher by 2050. This means that the average annual wage will be approximately $60,600 in 2030 and $98,210 in 2050 (measured in 1996 dollars.) By comparison, the average annual wage today is about $25,260, and the typical *couple* now receiving Social Security has an income of about $20,000.

Any tax increases that might be needed to finance Social Security in the next century would be small compared to these projected increases in real wages. For example, if the trustees' projections are accurate, Social Security could be supported indefinitely by increasing the tax by approximately 3 percentage points over the 30-year period from 2010 to 2040. This is less than the 4 percentage point increase in the tax from 1980 to 1990. A tax increase of this size would barely make a dent in the projected wage growth of future workers.

It is important to note that, while average wages are projected to rise substantially in the next decade, most workers will not see rising wages if most of the gains go to those at the top. This is exactly what has been happening in the economy over the last 20 years. Average wages have continued to rise, but the increase has been driven by the gains of those at the top. The median wage (the wage of a typical worker) has been falling for the last 20 years. If this trend continues, then future generations will experience declining living standards, but the source of this decline will be the institutional structures that allow wealth and income to be concentrated at the top, not a distributional problem between generations. It is often claimed that Social Security will provide a poorer return to future generations on the taxes paid in than it does for current and earlier generations. Yet this trend is not an accident. The nation as a whole is getting richer through time. Future generations will enjoy higher wages and incomes through their lifetimes as a result of the investments in infrastructure, education, technology, and capital made by earlier generations. Social Security transfers part of this wealth back to earlier, poorer generations. Younger generations therefore get a lower return on their Social Security taxes, but they get to enjoy a much higher living standard on the whole. In this sense, Social Security provides a progressive transfer between generations just as it provides a progressive transfer within generations.

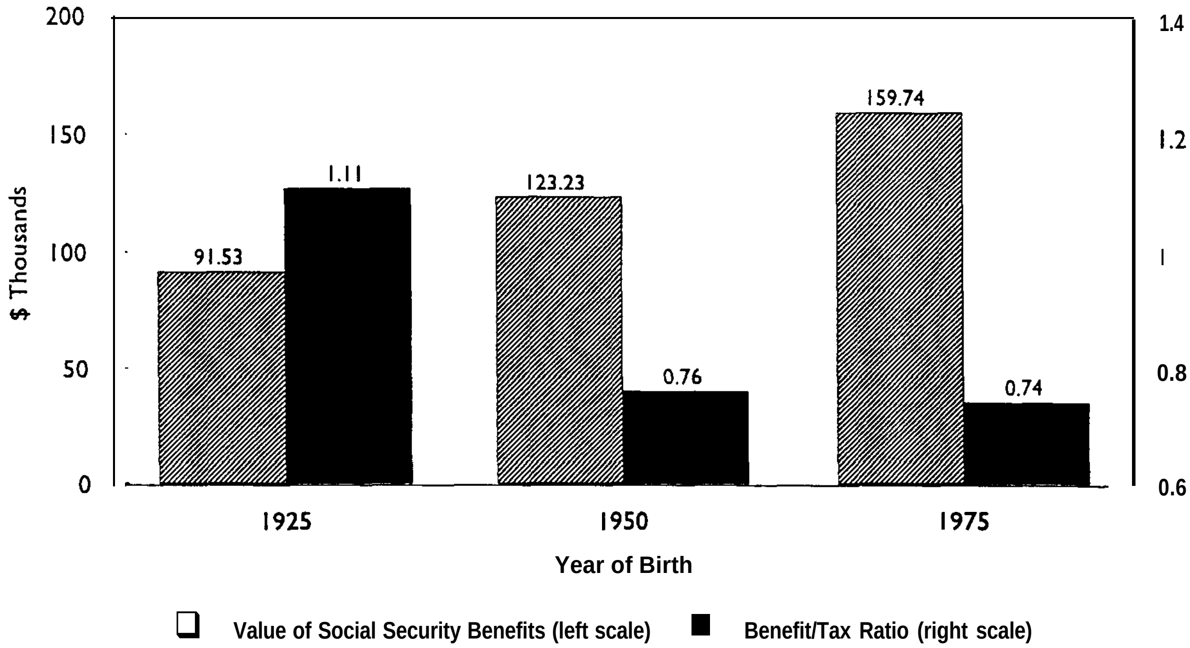
For this reason, it is inappropriate to compare the rate of return on Social Security taxes with the rate of return on stocks or bonds. Social Security is part of a policy package in which earlier generations created a public and private infrastructure to allow later generations to enjoy higher wages and living standards. The relevant measure is not the rate of return provided by Social Security benefits relative to the taxes paid in, but rather the improvements in living standards over generations. By *all* projections, younger generations will on average enjoy far higher standards of living than previous generations, even after paying their Social Security taxes. In addition, because of the Social Security benefits paid to their parents, millions of younger workers will not have to worry about providing for their parents' retirement at a time when they are raising their own families. (It is also important to remember that Social Security provides the equivalent of a $200,000 life and disability insurance policy for most of an individual's working life. The value of this policy is generally not included in calculating the return on Social Security taxes).

FIGURE A
Value of Social Security Benefits and Benefit/Tax Ratio
(Single Men, Born 1950)



Source: Steuerle and Bajika 1994.

FIGURE B
Value of Social Security Benefits and Benefit/Tax Ratio
(Average Income, Men)



Source: Steuerle and Bajika 1994.

Proposals for “Fixing” the System

The law governing Social Security requires that the fund show projections that it will be in balance for 75 years into the future. This requirement means that, even though the fund faces no crisis either at present or in the foreseeable future, changes must still be written into law that would allow for a positive balance to persist for the next 75 years. The President’s Advisory Council on Social Security has produced the three proposals discussed below.

The Ball Plan[1]—Preserve the Present System

This plan calls for maintaining the basic structure of the present system. It achieves a75-year balance through a series of steps to increase revenue and cut spending. The most important change on the revenue side is the decision to invest part of the current Social Security surplus in stocks, bonds, and other financial instruments. This would give the fund a higher rate of return than the government bonds it currently invests in. The major savings on the spending side derive from making all Social Security benefits in excess of contributions subject to federal income tax. Currently, only higher-income beneficiaries pay tax on their benefits. The plan preserves the current benefit levels and the progressivity of the benefit structure.

Partial Privatization Plans-Benefit Cuts, Taxes, and Chance

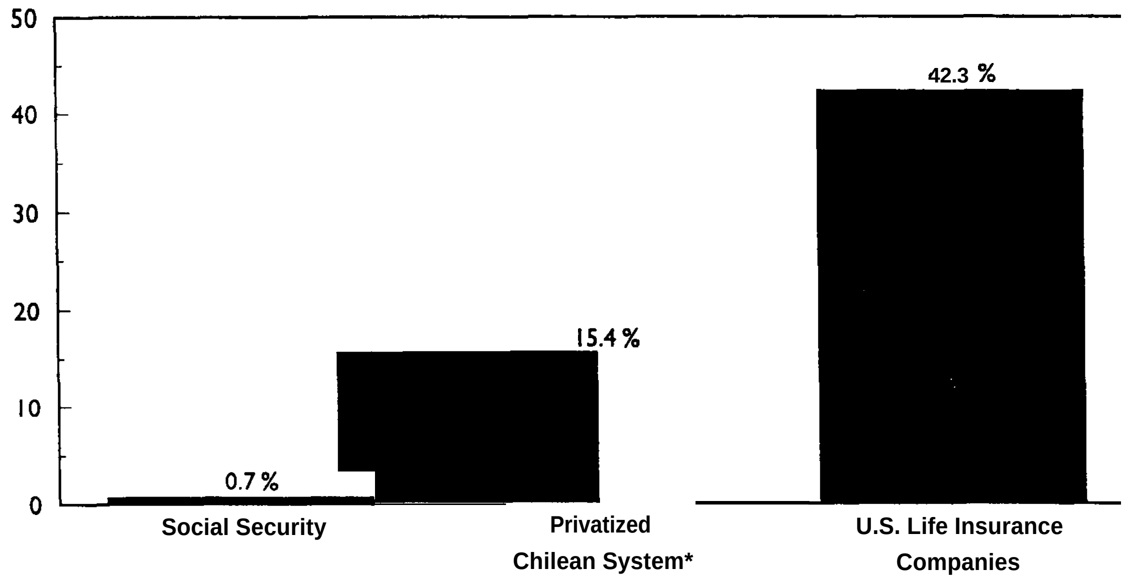
The commission also developed two proposals for partially privatizing Social Security. Both proposals call for cuts in benefits and increases in taxes. In addition, they would require individuals to speculate in financial markets with a portion of the money that they currently pay into Social Security.

This change has several clear implications. First, it creates a significant element of risk. Some people will inevitably do well with their investments while others will find they have much less for retirement than they had anticipated. People already have the option to speculate in financial markets with their retirement funds and other savings, but requiring that they do so with their Social Security undermines the basic principle that it be a universal program providing a fixed benefit based on taxes paid in.

Another implication is that the cost of managing the fund will soar. The system's current administrative expense ratio (0.7% of benefits) compares to 15.4% for Chile's privatized fund, which is usually held up as a model. The operating expenses of private life insurance companies total more than 40% of their annual payouts in survivor benefits and retirement annuities. Most of these expenses are associated with advertising and marketing, costs that are unnecessary under a single Social Security pool. Switching from a single centralized fund to a large number of separate funds guarantees an explosion in administrative costs.

The Gramlich Plan.[2] While it preserves most of the structure of the current system, the Gramlich plan would substantially reduce benefits for all but the poorest retirees. For example, a worker who earned on average $30,000 a year (in 1996 dollars) would be hit with approximately a 20% cut in benefits when the plan is fully phased in. This proposal incorporates many of the technical changes in the Ball plan, in-

FIGURE C
Operating Expenses as a Percent of Annual Benefits



Source: Board of Trustees, OASDI 1995; Vittas 1993; Vittas and Iglesias 1992; American Council of Life Insurance 1996.

* This number is operating expenses as a share of contributions. Because the system is relatively new, contributions vastly exceed benefits. Operating expenses are equal to 65% of the benefits currently being paid out.

cluding the taxation of all Social Security benefits in excess of contributions. It also calls for an immediate increase of 1.6 percentage points in the Social Security tax. This additional tax revenue would go into individual accounts administered by the government. The money in these accounts could be invested among a variety of government funds.

The Gramiich plan preserves some of the progressivity of the current system for the poorest retirees, but it would make Social Security a far less adequate retirement income for middle-class workers. The individual accounts will add significant administrative expenses with no obvious benefit. On average, individuals will do no better with their investments than the professional money managers who would control the whole fund under the Ball plan. This proposal merely adds an element of risk in which some will do well by guessing right with their investments while others will end up doing poorly. The return available to individuals will inevitably be less on average under the Gramlich plan because it will be costly to administer hundreds of millions of individual accounts. The costs incurred directly by individuals themselves will also be enormous. If each person enrolled in or receiving Social Security spent just 10 hours per year reviewing his or her investments, the expenditure of time would equal approximately $30 billion, or more than 15% of total net national savings.

The Schieber-Weaver Plan.[3] **The** more drastic privatization plan would gradually eliminate the basic structure of the Social Security system. In its place it would set up a minimal benefit level amounting to less than $5,000 per year. The rest of the individual's Social Security income would come from "personal security accounts," funded by a tax equal to 5% of their pay and placed in a registered saving account. Part of this fund would come from the existing Social Security tax and part from an immediate increase of 1.6 percentage points in the payroll tax. This system would be phased in over a series of years, with people currently receiving benefits or over 55 remaining under the existing system. People between 30 and 55 would be covered by a mix of the two, getting lower benefits than under the current system but higher benefits than they would under the privatization plan. Workers under 30 would be covered under the new system.

This system has all the drawbacks of the Gramlich plan, but the problems are magnified because it is more extreme. Instead of just cutting Social Security benefits by 20%, as in the Gramlich plan, it eliminates them altogether and replaces them with a sub-poverty-level benefit. The administrative costs will be even greater than under the Gramlich plan. Having a large number of private firms engaging in advertising and marketing will inevitably raise costs for individuals' savings. Some studies indicate that annual administrative costs of the Chilean system, on which this plan is modeled, account for 10% of the funds in the system.

In addition, the government will have to oversee the plans to ensure the soundness of the funds and to require that deposits are made regularly and kept in the personal security accounts. (The amount of additional government oversight would likely require a bureaucracy about the size of the Internal Revenue Service.) Also, as with the Gramlich plan, individuals will collectively spend the equivalent of hundreds of billions of dollars in time and money to select among the various accounts available.

The plan provides no guarantee of a secure retirement. If, for example, people placed their money in a fund that invested poorly or was fraudulently administered, they would be out of luck when they retired. Given the large number of "sophisticated" investors who were taken in with the savings and loan scandal or speculation in derivatives, it seems inevitable that many ordinary people will lose out to shrewd marketing schemes.

Again, compared to the Ball plan, this proposal is guaranteed on average to be a net loser. The investments people make will on average make no more money than the investments made by the professional investors who would manage the Social Security trust fund. The privatization plan, however, would require enormously higher administrative expenses (which would come out of retirement income) and would subject the public to far higher levels of risk.

The only clear winner from this plan is the finance industry. This plan uses the power of the government to force every worker in the country to place some of his or her earnings under this industry's control. The plan would not guarantee anyone a secure retirement, but it would guarantee large profits for Wall Street brokerages and banks.

Conclusion: Don't Play Games With People's Retirement

The Social Security system is an efficient system that has provided tens of millions of Americans with a decent retirement. There is no reason it cannot continue to do so indefinitely. The current system is progressive in that it provides higher percentage returns for poorer workers than for wealthier workers. It is also fair, in that people who pay more into the system get more out. Together with pension and personal savings income, Social Security is an essential part of most people's retirement income. It should not be shoved aside for faddish, ill-considered privatization schemes.

Endnotes

1. Robert Ball is a former commissioner of the Social Security Administration and a member of the President's Advisory Council on Social Security.

2. Edward Gramlich is chairman of the Advisory Council on Social Security.

3. Carolyn Weaver is a former commissioner of the Social Security Administration and is currently a member of the Social Security advisory council. Sylvester Schieber also is a member of the council.

Suggested Readings

American Council of Life Insurance. 1996. Washington, D.C.: unpublished data.

Baker, D. 1996. "Social Security: Don't Mess With Success." In Todd Schafer and Jeff Faux, eds., ***Reclaiming Prosperity: A Blueprint for Progressive Economic Reform*** Economic Policy Institute Series. Armonk, N.Y.: M.E. Sharpe.

Board of Trustees, OASDI. 1995. ***Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds.*** Washington, D.C.: U.S. Government Printing Office.

Steurle, C.E., and J.M. Bajika. 1994. ***Retooling Social Security for the 21st Century: Right and Wrong Approaches to Reform.*** Washington, D.C.: Urban Institute.

Vittas, D. 1993. "Swiss Chilanpore: The Way Forward for Pension Reform?" World Bank Policy Research Working Paper No. 1093, Washington, D.C.

Vittas, D., and A. Iglesias. 1992. "The Rationale and Performance of Personal Pension Plans in Chile." World Bank Policy Research Working Paper No. 867, Washington, D.C.