Why Social Security Should Be Privatized

A Commentary from Dallas Fed Research Director Harvey Rosenblum

FOR MORE THAN a decade, the Social Security system has been the "third rail" of American politics: touch it and you die! Over the last year or so, the conventional wisdom about *not* dealing with the issue of Social Security has shifted dramatically. It is as though someone sneaked into the train yard in the middle of the night and switched the rails when the public was asleep. Now hardly a day goes by without some mention in the media of the problems with the Social Security system, along with numerous proposals to "fix" it.

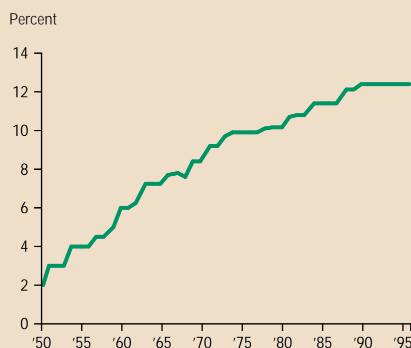
The reasons for the shift in attitude are simple: the Social Security system is in trouble and everybody knows it. Consequently, a number of reforms are being given serious consideration, including several that would have been considered radical just a few years ago. This article reviews some of the problems with the current Social Security system and discusses a few of the reforms that are worthy of consideration. The conclusion of the article, which might have seemed extreme two years ago, but is mainstream today, is seemingly an oxymoron: we need a *privatized* Social Security system.

Historical Overview

Social Security was created as part of the New Deal in 1935. It was intended to provide social insurance for the elderly and disabled. The program was designed to pay benefits to all households who contributed but was not intended to replace private savings and employer pensions.

Over the past 60 years, the program has expanded considerably. It now covers roughly 97 percent of the workforce. During this period, the rate of payroll taxation that funds Social Security has risen dramatically, as shown in Chart 1. Workers and employers are each currently taxed 6.2 percent—a total of 12.4 percent—on the first $65,400 earned. The employee and employer each pay an additional 1.45 percent tax on all wages that goes to Medicare. Workers' salaries, in the absence of these two taxes, could be up to 16.6 percent higher.[1] This likely contributes to the perception that middle-class incomes have been stagnating. In contrast, the payroll tax reduced take-home pay by only about 2 percent in 1950.

Chart 1
The Social Security Tax Rate Has Risen Six-Fold Since 1950



SOURCE: Social Security Administration.

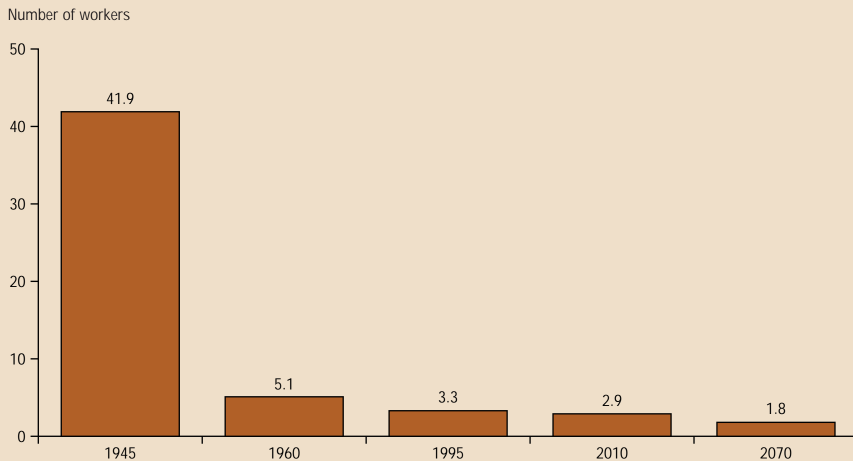
The growth in the size of the Social Security program relative to GDP has been even more dramatic, having grown from less than one-half of 1 percent of GDP in 1950 to over 4 percent today. By 2020 it is projected to transfer more than 6 percent of GDP from workers to beneficiaries.

By some measures, the program has been quite successful. For example, the poverty rate among the elderly, which had been twice that of the population as a whole, has been brought down to the same rate as that of other adult age groups.

Is There a Crisis?

Most people currently receiving their monthly Social Security benefits would say, "Crisis. What crisis?" This will be the prevailing view as long as the money keeps rolling in. However, projections indicate that if nothing changes, the program will be bankrupt in 35 years or less.

The current program is a "pay as you go" system in which the bulk of the money we pay in Social Security taxes is immediately paid out to current retirees and other beneficiaries. In recognition of the problems it faces when baby boomers retire, the Social Security Administration has been saving the difference between revenues and payments in a so-called trust fund. However, not only has there been an insufficient amount set aside to fund future payouts, but the funds have been invested in safe Treasury securities that



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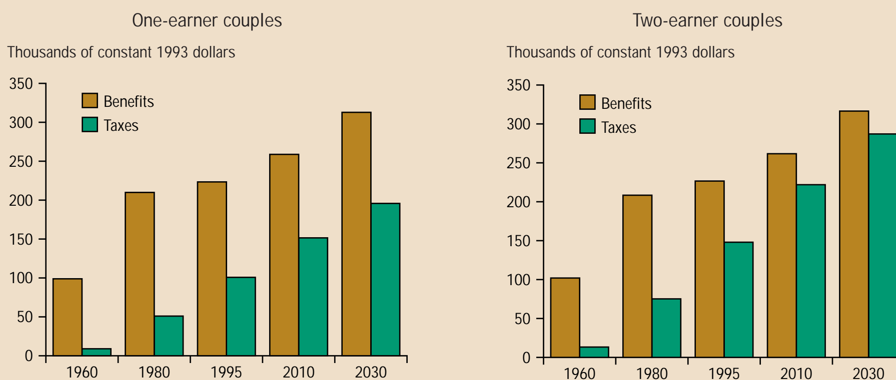
pay very low inflation-adjusted returns. Were it a private-sector pension fund, the federal government would likely label Social Security "an underfunded pension liability."

Sources of the Crisis

Given the rate at which Social Security taxes have been increasing, it is natural to wonder why we face a crisis. The two root causes are demographics and benefit escalation.

The first problem the program faces is the changing age mix of the population. The number of workers per beneficiary has been falling and will continue to fall for the foreseeable future. There were 42 workers contributing per beneficiary in the early days. The worker-to-beneficiary ratio has dropped to just over 3:1 today and is projected to fall below 2:1 by 2070 (*Chart 2*). The underlying causes include our declining birth rate, slowing rate of immigration and rising life expectancy.

Due to the increase in life expectancy, more people are receiving Social Security benefits for longer periods of time. Life expectancy has risen steadily, while the average retirement age has fallen. One reason for this trend is that we've become a wealthier society. The availability of Social Security benefits,



Social Security and Private Savings

Most older households do not have substantial retirement savings, making Social Security benefits the primary source of income for the majority of today's retirees. Median net worth of households aged 65–74 was slightly over $100,000 in 1995, mostly composed of home equity, according to the Federal Reserve's Survey of Consumer Finances. Only 35 percent of households aged 65–74 and less than one-fifth of households aged 75 and older had any savings in retirement accounts in 1995.[1] The median value of those retirement accounts was less than $30,000 for both age groups. About 40 percent of retirees have employer-provided pensions.

Of course, the promise of Social Security may be a cause of the low level of retirement savings among today's elderly. Some economists have concluded that the availability of Social Security benefits has reduced or offset private savings, particularly retirement savings.[2] Harvard economist Martin Feldstein concluded that the existing Social Security wealth reduces total private savings by almost 60 percent. The low level of private savings also slows GDP growth, Feldstein estimated.

Younger generations appear to be saving more for retirement, perhaps because of uncertainty about future Social Security benefits. About one-half of households aged 35–64 have retirement accounts, according to the 1995 Survey of Consumer Finances. Still, personal savings as a fraction of GDP in the United States is well below historical averages and international standards; personal savings were only 3.6 percent of GDP in 1996.

Notes

1 A. B. Kennickell, M. Starr-McCluer and A. E. Sunden, "Family Finances in the U.S.: Recent Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin* 83, January 1997, pp. 1–24. Retirement accounts include Keogh accounts, individual retirement accounts and 401(k) accounts.

2 E. T. Gullason, B. R. Kolluri and M. J. Panik, "Social Security and Household Wealth Accumulation: Refined Microeconometric Evidence," *Review of Economics and Statistics* 93, August 1995, pp. 548–51. See, in particular, the references therein.

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however, has also driven the decline in the retirement age.

The second major cause of the crisis is the fact that almost all current beneficiaries receive more in benefits than they contributed to the system, even after including the interest earned on their contributions. The first recipient of Social Security, Ida Mae Fuller, paid $22 in taxes and received $20,000 in benefits. Benefits are more in line with contributions now, but most current retirees receive more than the present value of their contributions. Chart 3 shows expected total benefits and taxes for the average retired one-earner and two-earner couple. If the worker in a one-earner couple retired in 1980, that couple could expect to receive more than four times the worker's total contributions, including interest.

The right-hand panel of Chart 3 shows benefits and taxes for the average two-earner couple. Again, the couple receives more than they contributed. Over time, benefits are getting closer to contributions, but benefits still exceed contributions.

These two graphs also illustrate one of the big inequities of the current program: it transfers money from single earners and two-earner couples to one-earner couples. The gap between taxes and benefits is much larger for one-earner couples than for two-earner couples.[2]

The Current Program Distorts Incentives

A discussion of the exact reasons Social Security is underfunded misses the bigger picture: the program distorts the incentives to work and to save. As Social Security coverage has increased, the retirement age has fallen. In addition, the program discourages recipients from continuing to work because benefits are reduced by up to 50 cents for each dollar in earnings. The distorted work incentives extend to younger persons, too. People may work less because the Social Security tax lowers their take-home pay.

The Social Security program may also distort the incentives to save. Some economists believe that having Social Security is one cause of the low savings rate in the United States (see the box entitled "Social Security and Private Savings"). In recent years, Americans have saved less than 4 percent of GDP; the savings rate in Germany is over 8 percent. In Japan, it is over 20 percent. Harvard economist Martin Feldstein believes that Social Security reduces private saving by 60 percent.[3]

Reform Criteria

Four overarching principles should guide Social Security reform. First, we need a system that motivates people to work and to save. Second, reform should more closely align benefits with contributions. Third, the long-run solvency of the system needs to be guaranteed. And last, we need a Social Security system that, unlike our current one, enhances our ability to achieve our nation's macroeconomic goals, such as economic growth and rising standards of living.

Band-Aid Proposals To Save Social Security

Several reform proposals, ranging from increasing the tax rate to switching to a privatized program, have been made. Each of these has advantages and disadvantages (see the box entitled "Summary of Proposals from the Advisory Council on Social Security").

A simple, and perhaps simplistic, way to cover the expected shortfall between benefit payout and Social Security tax collections is to raise the payroll tax. Baseline projections indicate that the tax would have to be raised by 2.2 percentage points to bring the system into balance for the next 75 years. More pessimistic scenarios, which are likely to prove more accurate, suggest that the tax would have to be raised by as much as 6 percentage points. Taxing our way out of this problem would clearly be very costly and, moreover, is not the correct solution from an economic standpoint anyway.

Another frequently heard recommendation is to revise the consumer price index (CPI). Cost-of-living adjustments to Social Security benefits are based on the CPI. Last December, the Boskin Commission concluded that the CPI was overvalued annually by about 1.1 percentage points. Over the long run, correcting the CPI would better align benefits with contributions and help Social Security remain solvent. Correcting the CPI is an important issue, but it should be done irrespective of Social Security reform.

Some economists and politicians have proposed changing the investment direction of the Social Security trust fund, which invests only in government securities. Investing some of the money in the stock market sounds attractive because stocks have historically outperformed returns on Treasury securities. Stock market returns have exceeded those on Treasury securities by more than 5 percentage points per year over the last few decades. Investing in both stocks and bonds is also good portfolio management. But is this something the *government* should do with Social Security?

Having the government put the trust fund in stocks raises several thorny issues. The year-to-year risk—that is, volatility—of stocks is considerably greater than that of Treasury bills. Although the higher return counterbalances the greater risk in the long run, Social Security might be underfunded in any given year if the market does not perform well over the short or intermediate term. Many of those who advocate investing Social Security contributions in the stock market presume that average past returns will also be realized in the future. Unfortunately, that is not how the stock market works.

There are more subtle disadvantages as well. Federal Reserve Chairman Alan Greenspan recently pointed out that "with the Social Security trust funds no longer investing all of their surplus in U.S. Treasuries, the federal debt held by the public would rise, presumably placing downward pressure on bond prices." Moving billions of dollars from

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government securities to the stock market might raise interest rates and thereby depress stock prices.

In addition, the government would become the single largest shareholder in many of the nation's largest companies. The temptation and pressure to use Social Security investments for social engineering by prohibiting investment in particular companies that engage in politically incorrect activities could become irresistible. This is not to deny that society would be better off with at least a sizable portion of its savings invested in high-yield equities, as opposed to 100 percent invested in low-yield government securities. But government, perhaps, should not be the guardian of those investments.

A system of individual accounts would restore our faith that we can provide for ourselves rather than having to look to government to take care of us.

Privatizing Social Security

Another reform proposal would create mandatory personal savings accounts. This reform is often called privatization or partial privatization because it would replace today's pay-as-you-go system with a system of individual retirement accounts. This proposal would do more to satisfy the four reform criteria enumerated previously than would just raising taxes, revising the CPI or investing in the stock market. Before examining the pros and cons of personal accounts, an explanation of how they might work is necessary.

Individuals would still be taxed on their earnings. However, a portion of those taxes would become privatized as the money would be split between two programs. The first portion would be contributed to the social insurance fund. This fund would help the elderly maintain a minimum standard of living, as was the original intent of our social insurance program. This fund would also provide a small monthly benefit to all contributors. Then, privatization would be implemented as the remainder of an individual's taxes would go into a personal account from which a person could withdraw funds at retirement. Individuals could invest their accounts in "approved" funds, including bank deposits and bond and stock mutual funds. Such a program would have to be phased in over time, and current recipients and those about to retire would likely continue to receive benefits under the existing system.

Creating personal accounts offers several advantages over the current system. First, it better aligns benefits and contributions. For most people, the majority of their retirement funds would come from their individual accounts, not from the social insurance fund. Better aligning benefits and contributions would improve the current pro-

Summary of Proposals from the Advisory Council on Social Security

In January, a federal advisory panel on Social Security put forth three comprehensive proposals for reforming the system. The 13-member council, formed in 1994, was asked to make recommendations to ensure the long-run solvency of Social Security. Members were drawn from academia, labor unions and private industry.

The *maintain benefits* plan recommends several ways to increase Social Security revenues to allow the current program to continue. First, the proposal would increase the payroll tax rate from 12.4 to 14 percent over 50 years. The plan also recommends investing up to 40 percent of the Social Security trust fund in private equities. A politically appointed panel would oversee the selection of index funds; equity investments would remain under government ownership.

The *individual accounts* plan recommends increasing the payroll tax by 1.6 percentage points and allocating the additional revenues to individual accounts. Individual accounts would be converted to annuities when holders retire. Regular Social Security benefits also would be paid. The individual accounts would be maintained by the government, but individuals would choose among several investment options.

Under the *personal security accounts* proposal, the basis of Social Security would shift toward a system of individual accounts. Five percentage points of the current payroll tax would be allocated to individual accounts, which would be supplemented by a flat benefit equivalent to $410 in 1996. The individual accounts would be maintained by individuals, not the government, and subject to investment restrictions. The program would be phased in over time.

gram's solvency. In addition, by making the accumulated value in one's personal Social Security account bequeathable, personal accounts would likely reduce the incentive to retire too early. A personal account program would be even more efficient if it ended the reduction of benefits for individuals who continue to work while receiving a payout from their account. The program would be self-financing in the long run but would involve transition costs to get to that stage.

Creating personal accounts would motivate people to work and save more, whereas our current system offers disincentives to both. It would also guarantee the long-run solvency of the system because most people would receive only what they had put into the system, plus investment earnings; even so, most future retirees would receive considerably more than they could hope to under the current program.[4] And last, personal accounts would help achieve our nation's broad macroeconomic goals. The current system depresses saving, capital formation and investment, thereby reducing productivity gains, lowering our standard of living and weakening economic growth. Recent estimates by Martin Feldstein suggest that GDP levels have been reduced yearly by 5 to 6 percent as a result of the disincentives and distortions of Social Security's payroll tax system. Creating personal accounts would boost both the saving rate and GDP.

Setting up personal accounts would increase costs in the short run. Current contributions must cover benefits to today's retirees and be allocated to the individual accounts of future retirees. Even under the existing system, however, Social Security's unfunded promises to current workers are estimated at $8 trillion to $12 trillion. Today's benefit levels simply cannot be maintained with today's tax rates. A boost in the payroll tax and/or other taxes, or a reduction in benefits, is required. One estimate is that the payroll tax could be boosted by as little as 1.5 percentage points for 25 years to cover the transition costs to a privatized system, after which, payroll taxes could decline well below current rates.[5]

Social Security Should Be Reformed

The nation has to make important choices about the future of Social Security. Minor modifications to the existing system will not work. The retirement portion of the system should be privatized through the creation of individual accounts that can be invested in a range of approved assets, with individuals maintaining control over their investments. Such a system would link the mandatory contributions of workers to their subsequent benefits. It would increase the nation's capital accumulation and raise future living standards. By reducing the insolvency problem of the current system, a system of individual accounts would restore our faith that we can provide for ourselves rather than having to look to government to take care of us.

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Notes

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1. Take the case of a worker whose salary is $100 per week. After a deduction of $6.20 for Social Security and $1.45 for Medicare, the worker takes home $92.35 before other taxes and deductions. The employer incurs a salary cost of $107.65 — that is, $100 salary plus $7.65 employer-paid Social Security and Medicare payroll tax. If the worker received the full $107.65, it would be like getting a raise of 16.6 percent. This example omits income tax effects.
2. Social Security also redistributes benefits away from groups with shorter life expectancy, such as black males, to those with comparatively long life expectancy, such as white females.
3. See Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," *American Economic Review Papers and Proceedings* 86, May 1996, pp. 1–14.
4. Chile began allowing workers to choose individual, privately managed accounts in 1981. Payments into the privatized system are estimated to be about one-third less than under the old system, while benefits are projected to be greater by more than one-third.
5. See Martin Feldstein and Andrew Samwick, "The Transition Path in Social Security," NBER Working Paper 5761 (September 1996).