

Social Security: The Real Deal

ISSUE BRIEF #1

“To Social Security Critics, The Argument Is Simple,” observed a recent headline in the *New York Times*. “Simplistic” is more like it, because proposals to convert Social Security into a system of personal retirement accounts ignore some pretty obvious facts and distort others. Let’s set the record straight:

Social Security works. Social Security is the most popular social program in U.S. history and has benefited Americans for sixty years. Almost half of today’s elderly would live in poverty without it. One in four people age sixty-five and older depends on Social Security for at least 90 percent of his or her income, and three in five count on it for at least half their income. Social Security provides the only disability protection for three-quarters of American workers.

Social Security is a “bird in the hand.” It offers a level of benefits that no “two in the bush” gamble on the private market can possibly guarantee. No private market investments provide Social Security’s risk-free protection against inflation. Moreover, the estimated value of Social Security’s disability policy is \$203,000. A similar dependent and survivor policy for a twenty-seven-year-old, average-wage worker with two children is worth \$295,000. Social Security provides Americans with a total of \$12.1 trillion in life insurance protection--\$1.3 trillion more than the combined value of all private life insurance policies of all types in the United States.

Social Security will not “crash” in 2032. The widely reported forecast that the Social Security system will be “bankrupt” or “insolvent” by 2032 is misleading. Even without any adjustments to the system and slower economic growth in the future, Social Security would be able to pay 75 percent of projected benefits to retirees. What we are facing is a projected shortfall in thirty years, not an imminent crisis.

The nation has met the baby boomer challenge before. It is true that as the baby boom generation retires, new beneficiaries will increasingly outnumber new contributors to

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the system. But remember that back when the boomers were still babies, their parents and the government found ways to provide for them, build new schools, and later finance an expensive college education for many of them. So even though there will be about 79 dependents (children and retirees) for every 100 workers in 2030 compared to 71 dependents per 100 workers in 1995, the ratio was a much higher 95 to 100 back in 1965. If America's much smaller economy could sustain such a large share of nonworkers thirty years ago, the retirement of the baby boomers should be manageable if the nation continues to pursue policies that promote strong economic growth.

The new taxes required to pay the transition costs of converting to a privatized system would be sky-high. Social Security is by and large a "pay-as-you-go" system funded by the payroll taxes of those currently working. Today's retirees and those about to retire are not simply going to disappear if we switch programs in midstream. Somebody is going to have to pay for the benefits of current Social Security recipients, and that somebody is those of us still working. Unless our parents move in with us, we will have to pay twice--for their retirement as well as our own. Estimates of the new taxes required range from 3 percent of taxable payroll for thirty-five years or about 1.5 percent for seventy-two years--a long and costly transition indeed. Factoring in those costs, the "rate-of-return" on Social Security for today's workers would fall well below both projected inflation and the level that the current system would provide.

Today's younger working families would feel the squeeze. Testifying before the Senate Budget Committee Task Force on Social Security, Alicia H. Munnell, who holds the Peter F. Drucker chair in Management Sciences at Boston College's Carroll School of Management, described the burden these transition costs would impose on her son Hamilton, his wife Pamela, and their one-year-old daughter Brittany:

The argument being made by [the] Heritage [Foundation] and others is that if we move from a pay-as-you-go to a funded system, Brittany--my granddaughter--will be able to earn as much as 7 percent on her accumulated reserves as opposed to less than 2 percent under the current system. If one assumes away transaction costs . . . and assumes 100 percent investment in equities, that is, more or less, true.

The key issue, and the one completely ignored in the Heritage study, is how do we get from here to there. The transition would place very large transition costs on Ham and Pam. They would have to continue paying benefits to current retirees and those near retirement like me and my husband, and at the same time they will have to make additional contributions to build up their own accumulations (in order to avoid placing a burden on Brittany). In other words, they have to pay twice.

How big would these transition costs be? The most careful cost estimates come from the 1994-1996 Advisory Council on Social Security's analysis of the so-called Personal Security Accounts (PSA) plan. Remember that this plan involves only partial funding; more than half the program would continue to function on a pay-as-you-go basis. Nevertheless, proponents of this plan calculate that the transition would require a tax increase equal to roughly 3 percent of taxable payrolls for roughly thirty-five years. That means that Ham and Pam would face a 3-percentage point increase in their Social Security payroll tax. . . .

Because the transition costs are inescapable and because they are large, policymakers have to balance the well-being of Ham and Pam's generation against the well-being of Brittany's generation.

Administrative costs and fees would hand billions to Wall Street that retirees now receive. Social Security now spends in the neighborhood of 1 percent of total program expenditures on administration. Private insurance has much steeper administrative costs-- 12 to 14 percent of expenditures, according to the American Council of Life Insurance. It is estimated that the privatization proposal favored by Wall Street would cost \$240 billion in investment management and administrative fees between now and 2010. This would reduce the rate of return that beneficiaries receive by a full percentage point.

Social Security is especially valuable to women, minorities, and low-income workers. Women, minorities, and others who tend to earn the least benefit the most from Social Security's progressive payment structure. When they retire, they have a greater percentage of their wages replaced by Social Security than is the case for high-income earners. In addition, workers with low wages are guaranteed at least a minimum benefit. This is especially important for women, who, by virtue of their living longer than men as well as generally earning less, would otherwise be at greater risk of outliving their

savings. And while under the privatized plan the elderly can outlive their personal accounts, Social Security benefits are guaranteed for the life of the recipient.

Beware of the race card. Some opponents of Social Security cite data that African-American males have shorter life expectancies and therefore enjoy retirement benefits for a shorter period of time than white beneficiaries. This ignores the other benefits Social Security provides African-American families. Although African-Americans represent 12 percent of the U.S. population, 25 percent of the children awarded deceased worker benefits in 1996 were African-American, as were 18 percent of those receiving disability benefits. And because black males have lower average earnings than white men, they are more likely to receive a higher “return” from the system if they live longer than the average for their demographic group.

The “new math” of privatization advocates does not add up. Advocates of privatization claim that investing in the stock market will yield an average annual return of 7 percent over the next seventy-five years, which approximates its performance over the past seventy-five years. But that claim cannot be reconciled with the projection by the Social Security Trustees that U.S. economic growth will decline from its average of roughly 3.5 percent during the past seventy-five years to 1.6 percent over the next seventy-five. It was this forecast that led to concerns about a Social Security shortfall in 2032 in the first place. Privatization advocates cannot have it both ways. If the market continues to yield 7 percent returns for the next seventy-five years, the economy will have grown much faster than 1.6 percent annually, and Social Security will be so flush with increased FICA contributions that there will be no need to fix a system that isn't broken. And if economic growth does indeed turn out to be anemic, market returns will be, too.

In “Saving Social Security with Stocks: The Promises Don't Add Up,” a 1997 Twentieth Century Fund/Economic Policy Institute report, Dean Baker, an economist at the Economic Policy Institute, calculated that if the Trustees' projection is correct, the average rate of return on equity investments will be in the neighborhood of 4.4 percent. In the final analysis, stock market advocates are hoist on the petard of their own economic projections.

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