10 Myths About Social Security

ISSUE BRIEF #3

MYTH NUMBER 1: Social Security will have to stop payments to retirees in 2032.

It is true that the government projects that the Social Security Trust Funds, now growing by more than $100 billion a year, will be drawn down to zero in 2032. But those same estimates also show that, in that year, Social Security payroll taxes will be sufficient to finance about 75 percent of the payments that will be owed to the program's beneficiaries. Over the next 75 years, the gap between revenues and payments amounts to just a bit more than 2 percent of the income projected to be subject to the payroll tax. Therefore, what we face is a possible shortfall after 2032, not an immediate crisis or impending collapse.

Although the lack of savings in the Trust Funds after 2032 is not good news, Social Security has had minimal reserves throughout most of its history. In the past, payroll taxes from workers were just enough to meet payments to beneficiaries. Congress created today's large and growing Social Security Trust Funds, financed by the excess of current payroll taxes over payments to current beneficiaries, to help the system meet the challenge of supporting members of the baby-boom generation who will begin to retire after 2010.

MYTH NUMBER 2: We would all do better if Social Security were replaced, in whole or in part, by a system of individual private accounts.

Today's Social Security offers important benefits that a system of private accounts would not. For one thing, Social Security provides a government-guaranteed lifetime stream of payments, adjusted for inflation, for retirees. Benefits from private accounts, in contrast, depend on how much one saves and how well individuals' investment choices work out. Moreover, Social Security is a unique insurance program that protects against a variety of risks: disability that leads to lost earnings, the death of a working spouse, inadequate pension coverage, high inflation during retirement, and outliving one's assets. Investment accounts do not protect against risks; they are risky in their own right.

In any event, moving from today's pay-as-you-go system to one that is private and prefunded would require a substantial tax increase in order to continue financing benefits to current retirees while creating new accounts for today's workers. Advance funding of future pensions--whether through the current system or by privatization--is therefore impossible without additional funds from either new taxes, lower benefits, or an increase in the national debt.

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(212) 535-4441 ♦ info@tcf.org ♦ http://www.tcf.org
41 East 70th Street ♦ New York, NY 10021

Because of the inevitable transition costs to a new system with private accounts, the rate of return relative to tax contributions for current workers, young and old, would be lower than it would be under today's Social Security. In fact, addressing the possible shortfall in Social Security by conventional means without creating private accounts would provide a higher return well into the next century.

The privatization plans backed by a minority of the recent Social Security Advisory Commission would require about $6.5 trillion in additional taxes over the next 72 years. Another estimate calculated that the transition would necessitate a tax increase equal to approximately 3 percent of taxable payrolls over the next 35 years--substantially higher than the 2 percent increase that would eliminate the projected shortfall. Most privatization proposals also impose steep cuts in guaranteed benefits, on the order of 30 percent below current levels.

MYTH NUMBER 3: The Social Security Administration is a big government bureaucracy that wastes a lot of taxpayers' money.

Administrative costs for Social Security are about 1 percent of benefits, compared with average administrative costs of 12 to 14 percent for private insurers. In Chile, which instituted a system of mandatory private savings accounts, estimated overhead costs exceed 20 percent. Still, public opinion polls by Roper show that the public mistakenly guesses the administrative costs of Social Security as a percentage of benefits to be more than 50 percent.

MYTH NUMBER 4: The Social Security Trust Funds are an accounting gimmick filled with worthless IOUs.

As of the end of 1997, the last year for which published figures are available, the reserves in the Social Security Trust Funds amounted to $656 billion in U.S. Treasury obligations. U.S. commitments are viewed throughout the world as the safest investment available. Indeed, investors seeking safe returns think first of Treasuries.

Because of the impending retirement of the baby-boom generation born between 1946 and 1964 and other demographic trends, the Social Security Board of Trustees projects (under its intermediate set of economic assumptions) that, beginning in 2013, annual benefits will exceed payroll tax revenues. From 2013 to 2021, under those same assumptions, interest generated from the Trust Funds' Treasury securities would be needed to meet Social Security obligations. For the next 11 years, it would be necessary to use the Trust Funds' principal as well to meet outlays. Those projections anticipate that the Trust Funds will be depleted in 2032, leaving the system purely pay-as-you-go--just as it was from the 1940s through the 1960s.

Without the Trust Funds' reserves, the moment when the government would need to find a solution to the gap between payroll tax revenues and obligations to retirees would be moved forward by 19 years, from 2032 to 2013.

MYTH NUMBER 5: Unprecedented economic growth would be needed to prevent Social Security's collapse.

The intermediate, and most widely cited, economic forecast of Social Security's trustees projects that the average annual increase in U.S. gross domestic product, adjusted for inflation, will be only 1.6 percent from 1997 to 2029. In contrast, the growth rate from 1960 to 1974 averaged 4.1 percent; and from 1975 to 1996, it averaged 2.7 percent. The main reason for the forecast of dramatically weaker economic performance than the nation has experienced in the past is the likely decline in the rate that the workforce will grow.

But a variety of factors could boost economic activity beyond the intermediate forecast's anemic (by historical standards) levels. More immigration, stronger productivity growth, increased household savings, and greater capital investment would all help raise future economic performance, bringing it closer to past levels. Maintaining current levels of economic growth would sustain Social Security through the next century without any changes in the program.

MYTH NUMBER 6: The ratio of nonworkers to workers will reach unprecedented heights during the next few decades, imposing unsustainable burdens not just on Social Security but on the entire economy.

It is true that because of the aging of the baby-boom generation, longer life expectancies, and declining birthrates, more than 20 percent of all Americans will be elderly after the year 2030--a greater proportion than ever before. That means that Social Security benefits for this larger number of retirees will be paid from taxes collected from a relatively smaller pool of workers. In 1995, there were nearly five people between the ages of 20 and 64 for every person aged 65 and over. Demographers estimate that in 2030, when today's young workers begin to retire, there will be slightly fewer than three people between the ages of 20 and 64 for each person 65 and older.

But the elderly are not the only nonworkers. It is important to remember that when the boomers were babies, their parents and the government found ways to provide for them, to build new schools, and later to finance an expensive college education for many of them. So even though there will be about 79 dependents (retirees and children) 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 far smaller economy could sustain such a large share of nonworkers 30 years ago, the retirement of the baby boomers should be manageable as long as the nation continues to pursue policies that promote strong economic growth.

MYTH NUMBER 7: Compared with the private investment market, Social Security provides a meager payoff to workers relative to their lifetime contributions.

Widely quoted studies about low future "rates of return" on Social Security taxes are misleading for a number of reasons. Foremost among those reasons, as explained under myth number two, is that Social Security is fundamentally an insurance policy rather than an investment account. Specifically:

1. Rate-of-return studies leave out the value of the insurance protections that Social Security provides. For example, the estimated value of Social Security's disability policy is $203,000. A similar dependent-and-survivor policy for a 27-year-old, average-wage worker with two children is worth $295,000. In all, 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.
2. By ignoring the higher taxes that would be needed to make the transition to a system of private accounts, the studies greatly overstate the rate of return on such accounts. Paying in a lot more at the outset to fund the new accounts while continuing the benefits of current retirees could, in many cases, leave today's workers with negative returns from the accounts. Indeed, a recent analysis by the Employee Benefits Research Institute concluded that, among a wide range of reform proposals, the one that would generate the highest returns on payroll tax contributions would be simply raising the payroll contribution without making any other changes to the current system.
3. Those reports neglect the enormous benefit that current workers derive from the Social Security payments that their retired parents and grandparents receive. Without Social Security, which is financed by the payroll taxes that today's workers pay, middle-aged and young families would face a far greater burden in directly providing for their elderly parents and relatives.
4. Those analyses fail to explain that Social Security retirement benefits are tied to each worker's past earnings history and marital status, while private investments are vulnerable to a wide range of risks. The projected, annualized "return" of 2 to 4 percent in excess of inflation for most low- and middle-income workers is actually a high payoff for a safe investment. Investing in private accounts might produce higher returns, but the risks of actually losing money would also be much higher.
5. Rate-of-return studies typically ignore the fact that no private market investments provide Social Security's risk-free protection against inflation. While Social Security's benefits increase each year to offset price increases, almost all private market pensions and investments do not. So even though retirees with ample nest eggs may eventually outlive their savings as inflation erodes the value of a fixed income, they cannot outlive their Social Security retirement benefits.
6. Those studies generally don't count the extent to which workers' contributions to private accounts would be swallowed up by investment management fees, commissions, and overhead charges. Factoring in potentially double-digit costs significantly reduces the rate of return to private accounts.

MYTH NUMBER 8: Social Security would have to be dramatically transformed to take advantage of higher potential long-term investment returns in the stock market.

Congress could enact a law allowing new contributions to the Social Security Trust Funds to be invested in a broad, diversified portfolio of stocks rather than confining its holdings to Treasury securities. Such a plan could provide an added cushion of support for the program to delay the estimated date when the Trust Funds' assets would be fully spent. And unlike private accounts, which would leave individuals vulnerable to actual losses if they invested unsuccessfully, all beneficiaries would still be owed their full benefits regardless of swings in the markets of the Trust Funds' purchased stocks.

Although the 1994-96 Advisory Commission on Social Security had internal disagreements on many issues, a majority supported several incremental reforms that together would erase more than 70 percent of the projected long-term shortfall in the system. Those changes include: 1) increasing the working period over which a retiree's benefits are computed from 35 to 38 years; 2) changing the way in which Social Security benefits are taxed, so that any benefits a retiree receives beyond what he or she contributed to the system as a worker would be taxed as ordinary income; 3) extending Social Security coverage and participation to 3.7 million state and local government employees who are currently excluded from the program; 4) accelerating the scheduled increase in the retirement age so that it becomes 67 by 2011; and 5) technical changes in the way the consumer price index is calculated.

The remaining shortfall would be about 0.5 percent of taxable payroll. Other minor tax and benefit adjustments could close that gap. Shifting additional revenues from the Trust Funds into a widely diversified portfolio of stocks to generate higher returns over time might also do the trick. But Social Security's current structure and underlying principles would not have to be transformed to address the problem.

MYTH NUMBER 9: African-Americans and Latinos benefit least from Social Security and have the most to gain from a privatized system.

This argument is based on the fact that African-Americans and Latinos have shorter life spans than whites and therefore collect retirement benefits for fewer years on average. But African-Americans and Latinos also have lower earnings, on average, than whites. Because Social Security's retirement benefits replace a larger share of past earnings for low-income versus high-income beneficiaries, African-Americans and Latinos receive a higher annual payoff in comparison to their past tax contributions than whites. Because African-Americans and Latinos on average have lower savings rates, fewer assets, and less extensive pension coverage than whites, they also are more likely to be highly dependent on Social Security benefits. Moreover, while African-Americans constitute 12 percent of the U.S. population, 25 percent of the children awarded deceased worker benefits in 1996 were black, as were 18 percent of the workers who received disability benefits.

MYTH NUMBER 10: The elderly generally enjoy comfortable living standards and would have little difficulty getting by if Social Security benefits were less generous.

Without Social Security, which in 1996 provided an average benefit of $745 a month (slightly less than $9,000 a year), about half the elderly in America would fall below the poverty line. A significant proportion of the elderly depend on Social Security to survive: in 1994, 66 percent of the elderly in America relied on Social Security for at least half their total income. Only 7 percent of the elderly have total annual incomes in excess of $75,000. Largely because of Social Security, poverty rates among the elderly have declined from 35 percent in 1959 to slightly more than 10 percent in 1996.