The American Voice 2004: A Pocket Guide to Issues and Allegations

Issues and Allegations: Social Security Policy

Background

All societies must wrestle with the matter of what to do with their aged and infirm. In the 20th century most industrial nations created programs to enhance the financial security of these two vulnerable groups. In the United States the key program is known as Social Security. Officially known as Old Age and Survivors and Disability Insurance (OASDI), Social Security is actually two separate trust funds, one for retirement and survivorship benefits (OASI) and another for disability benefits (DI).

Over 80 percent of Social Security revenues come from payroll taxes (a 10.60 percent tax on wages for OASI and an additional 1.8 percent for DI for a total of 12.4 percent).**[1]** The rest comes from income taxes paid on Social Security benefits**[2]** and interest income from treasury bonds purchased when Social Security revenues exceed expenditures.

Begun in 1937, OASDI goes beyond a simple retirement program. While providing retirement benefits to workers, it also affords them to their spouses and dependents. And it offers benefits to family members of workers who have died, as well as disability benefits to workers who become disabled before retirement (not necessarily as a result of work-related injuries).

In 1939 the maximum Social Security benefit was $494 per year ($6,326 in 2001 dollars). In 2001 the maximum annual benefit payable to a single participant retiring at age 65 was $18,456. Currently Social Security benefits automatically rise at the rate of inflation. The program guarantees payments for the life of the beneficiary.

The Social Security benefit schedule is progressive, meaning that it helps lower income workers more than higher income workers. One study by Bernard Wasow of the Century Foundation estimated that the poorest 20 percent of male workers receive about $2.75 for every dollar of payroll taxes paid. For women, who are poorer and live longer, the ratio is 6 to 1. The richest 20 percent of male wage earners receive 80 cents for every $1 paid in. Female wage earners receive a little over $1.

In 2002 Social Security distributed benefits to more than 46 million Americans, some 39 million through OASI and an additional 7 million under disability. About 3 million of the beneficiaries were under 18.

Social Security is the single most important source of income for elderly Americans. For all households where the head of the household is 65 or older, almost 60 percent of their income comes from Social Security. For the poorest 40 percent of these households Social Security provides 80 percent of their income.

The problem

People are living longer, and a large number of baby boomers are about to retire. The combination will decrease the number of Social Security contributors while increasing the number of recipients.

In 1990 3.4 workers were contributing to Social Security for every one beneficiary. This ratio will fall to 2.1 in 2030 and 1.9 in 2080.

The law governing Social Security requires that the fund show projections that it will be in balance for 75 years into the future. Recent projections indicate the Trust funds will be unable to pay 100 percent of their obligations by 2042.

At a Glance...

The conservative view:

- Social Security is a huge financial crisis waiting to happen. Major reforms are needed.
- Higher returns can be achieved by investing in stocks and bonds.
- Personal retirement accounts have been successfully implemented in many countries.
- Personal retirement account plans can be structured to include a safety net that guarantees a minimum level of income for all retirees.
- Conversion of personal retirement accounts to annuities at retirement eliminates seniors' financial risk during their retirement years.
- Personal retirement accounts can be passed on to heirs.

The liberal view:

- Modest reforms could correct any Social Security shortfall.
- Shortfall projections are based on highly pessimistic forecasts of economic growth while the performance of personal retirement accounts is based on optimistic economic forecasts.
- Averaging stock market growth over 75 years gives the appearance of consistent returns, when in fact there have been several extended periods of low returns. Luck, investment savvy and the date of retirement could determine retirees' income and therefore financial security.
- The Social Security system is highly efficient. Private accounts will increase overhead costs.
- Recent evidence of widespread malfeasance by the financial industry indicates that a high level of policing and the costs associated with that will have to accompany privatization.
- Personal retirement accounts will divert money from funds required to pay current retirees. Thus there will be very high transitional costs. For the next thirty years, privatization will require working adults to pay twice – once for their own personal account and once for current retirees.
- Personal retirement accounts will offer little choice. To limit complexity and overhead costs only a small number of large funds will manage these accounts.

Back in1983, Congress recognized the looming demographic and thus financial problem and raised Social Security taxes in a bipartisan effort. This "fix" is creating a huge surplus that will begin to be drawn down around 2017. The government invests surpluses special nontradable federal securities. As an aside, Social Security's surplus is usually included in overall federal budget deficits, concealing the true extent of such deficits.[3]

- To guarantee financial security to retirees the personal retirement account will have to be converted to an annuity. Private firms will charge the retiree to make that conversion.
- If the personal retirement account is converted to an annuity it cannot be passed on to heirs.

The conservative perspective

Conservatives paint a dire picture of Social Security's future. The Heritage Foundation sees "an immense financial crisis." "Without reform the Social Security retirement program will run an annual deficit of $594 billion (in 2001 inflation adjusted dollars) by 2075."[4] President Bush announced, "If we do nothing to reform the system, the year 2037 will be the moment of financial collapse."[5] President Bush, in a speech on the formation of the Social Security Commission asserted, "Today, young workers who pay into Social Security might as well be saving their money in their mattresses."[6]

The principal component of the conservative solution diverts a portion of the Social Security taxes to a new program of personal retirement accounts for beneficiaries. The Bush administration urges this strategy. President Bush has said that if he is elected to a second term he will immediately "come out strong" with "privatizing of Social Security." [7]

Conservatives posit that the higher yield from these investments compared to that of the treasury bonds in which the trust funds currently invested will satisfy 100 percent of the fund's long term obligations.

David C. John of the Heritage Foundation notes that since 1802 stocks have earned an average 7 percent a year after inflation, ". . . stocks and bonds give workers a much higher rate of return than the current form of Social Security can offer . . ." Despite recent stock market losses, he observes, personal retirement accounts invested in stocks for the last 40 years would pay almost three times more in retirement benefits than today's Social Security.[8]

Peter Ferrara of the Institute for Policy Innovation asserts, "Social Security's aging pay-as-you-go system offers today's workers a low, below-market return on the taxes they and their employers pay into the system…These workers would now be able to get far higher returns and benefits relying on diversified investments in the capital markets."[9]

President Bush notes, "Right now, the real return people get from what they put into social security is a dismal two percent a year. Over the long term, sound investments yield about a six percent return. Investing that four percent difference, over a lifetime, can show dramatic results."[10]

Conservatives note that in recent years personal account systems have been adopted successfully in many countries, including Hungary, Poland, Switzerland, Denmark, Sweden, Chile and England.

Some conservative proposals recognize the possible risk involved in stock market investments. To minimize this risk, they would establish a guaranteed safety net so that worker cannot fall below a minimum floor of benefits.

Virtually all current proposals deal with the risk issue by establishing personal retirement accounts that require workers to convert them into annuities at retirement. An annuity converts all or part of the nest egg into a specific guaranteed benefit for the life of the beneficiary, similar to what Social Security does now.[11]

Some conservatives maintain that no system is risk-free, even the existing one. As one report from the Heritage Foundation states, "Social Security is subject to the risk that future generations may not be willing to pay the ever-higher costs of the promised benefits."[12]

The liberal perspective

The liberal view, embraced by most Democratic leaders, views the projected Social Security shortfall as modest and possibly exaggerated. Liberals point out that even after 2042 Social Security will continue to be able to pay 75 percent of its benefits. Thus they insist the term "bankruptcy" is inappropriate and alarmist. Modest reforms can resolve the shortfall.

For example, raising the OASDI tax from 12.4 percent to 14.3 percent guarantees a 75-year solvency. This hike compares to the level of increase Congress negotiated in 1983.[13] The Social Security tax could be applied to all wage income rather than only the first $87,000. This change would eliminate the shortfall while affecting about 6 percent of the work force.[14]

Liberals dispute the pessimistic economic assumptions upon which the Social Security Board of Trustees bases its revenue projections. The trustees posit a real economic growth rate of 1.7-1.8 percent over the long term and a productivity growth rate of 1.6 percent. These projections are very low by historical standards.

Liberals point out that in the last 10 years the economic projections of the trustees have been far exceeded, continuing to push back the time when the trust fund will be unable to pay 100 percent of its obligations. In the 7 years from 1996 to 2003, the date at which Social Security will fail to meet 100 percent of its obligations has been pushed back 13 years.

Changes in Social Security Board of Trustees' projections

Trustee report date	**1996**	**1999**	**2000**	**2003**
Date at which additional revenue will be needed	**2029**	**2034**	**2037**	**2042**
Source: 2003 Annual report of the Board of Trustees of the Federal Old-Age Survivors Insurance and Disability Insurance				

Liberals point out that conservatives promoting personal retirement accounts often rely on rosier economic projections than do the Social Security trustees, which exaggerates the difference in yields. A 1998 proposal illustrative of privatization alternatives supported by most congressional Republicans assumes that an account with 60 percent invested in stocks and 40 percent in bonds would yield an inflation adjusted annual return of 5.5 percent, "the average return on (such a portfolio) during the post war period through 1994". But when one substitutes the lower economic growth projections used by the Social Security trustees, the yield falls from 5.5 percent to 3.5 percent.**[15]** This returns only slightly more than the long-term yield for treasury securities of 2.8 percent.

Alternatively, if the Social Security administration were to adopt the more optimistic economic growth projections of those who advocate personal retirement accounts, the projected shortfall would largely disappear.

Bernard Wasow, economist and senior fellow at the Century Foundation, notes the different way in which the private and public sectors evaluate the health of their pension plans.**[16]** The Social Security trustees are required to use consistent data and provide long range forecasts that can easily be compared to earlier ones. Such consistency and transparency is not required of private pension fund managers. Companies have wide latitude in choosing their accounting assumptions for their annual reports. Self-interest encourages overestimating future economic growth and financial returns because the rosier the projections the less the company needs to invest today to meet its pension obligations. Every percent of increase in projected yield reduces a company's pension funding requirement by 10-15 percent.

During the past few years private pension funds have convinced their regulators to raise the interest rate used to assess their adequacy. Under old rules the assumed a rate of return was about 5.8 percent. The new rate is 6.7 percent and companies are lobbying to increase this to 7.4 percent, which, as Wasow notes, is near junk bond territory.

Liberals assess the risk of equity investments as much higher than conservatives assume. Liberals agree with conservatives that over the past 75 years, the inflation adjusted annual return on stocks averaged 7 percent, but in assessing retirees' security, they insist that additional historical data should be reviewed.

The 20th century witnessed three 20-year periods, 1901-1921, 1928-1948 and 1962-82 when the average real return on stock market investments was zero. The average real rate of return for the stock market was only 1 percent from 1962 to 1981 but was 12.5 percent from 1980 to 1999. Retirement income under a privatized system would depend on the stock market, luck, investment savvy and the timing of the worker's retirement.**[17]**

Liberals note that President Bush specifically directed the Social Security Commission not to include a scenario in which the Social Security trust funds themselves could be invested in equities or corporate bonds. His directive could be followed only through creating privately managed accounts, a strategy that requires additional administrative fees. The existing Social Security system's overhead is a little less than 1 percent.**[18]** Privately managed accounts would have higher overhead costs. Additional expenses would be incurred in converting an individual account into an annuity.

Liberals agree with conservatives that a growing number of workers are being covered by pensions and employer-assisted retirement accounts, almost half the workforce as of late 2002.**[19]** They disagree about the implications of this trend. The adequacy of retirement savings declined during the 1990s even though stock market soared. The share of households between ages 47 and 64 that were able to generate $1,000 of monthly retirement income declined between 1989 and 1998, as did the share of the same households that were able to replace 50 percent of their income. By one estimate, two thirds of American households headed by 47-64 year old workers with pensions in 1998 had the same pension wealth or less when adjusted for inflation than they did in 1983, even though the annual rate of return for stock market was 12.5 percent a year 1980 to 1999.**[20]**

Liberals highlight the recent disclosures of widespread fraud and manipulation by money managers as a reason not to shift Social Security assets to private managers. Arthur Levitt, former Chairman of the Security Exchange Commission has declared that a system of individual accounts would require "an unprecedented level of broadscale policing" to prevent fraudulent practices.**[21]**

Finally liberals also note the enormous transitional costs of privatizing even a small portion of Social Security funds. The money diverted into personal retirement accounts would need to be replaced in order to pay traditional benefits to workers for the next few decades. This amounts to hundreds of billions of dollars in increased short-term costs.

Finally, although conservatives talk about retirees having control of their personal retirement accounts liberals point out that all proposals require the use of only a handful of huge funds. Thus it is unclear how much choice and control an individual could exercise.

Notes and Sources

- **A note on internet citations**

[1] The employer pays 50 percent and the employee pays 50 percent. Those self-employed pay 100 percent.

[2] Under current law individuals earning less than $25,000 and married couples earning less than $32,000 do not have to pay taxes on their Social Security benefits. Those earning $33-44,000 pay taxes on 50 percent of their Social Security benefits and those with incomes from $45-87,000 pay income taxes on 85 percent of their Social Security benefits. Income above $87,000 is untaxed. Today only 20 percent of people who receive Social Security pay taxes on their benefits.

[3] Adding in Social Security funds to the revenue side of the federal budget even though they are already legally obligated for future expenditures obscures the size of the deficit. For example, in 2000 Social Security trust funds received $150 billion more than they paid out. The federal surplus that year was reported to be $232 billion but without the Social Security trust funds it would have dropped to $84 billion.

[4] Mark D. Wilson. **Heritage Foundation Reports**. October 17, 2001

[5] George W. Bush. **"A Defining American Promise"**. Speech at the Ranco Cucamonga Senior Center. May 15, 2000

[6] George W. Bush. **Announcement of formation of Social Security Commission**, May 02, 2001

[7] President's Social Security Commission. Recommendations were released December 2001. The Commission developed three scenarios. All were required to be guided by certain principles. There could be no increase in taxes. There could be no investment by the existing funds in the stock market. Each scenario had to propose the privatization of part of the trust funds into personal retirement accounts. Ron Suskind, "**Without a Doubt**", *New York Times*, October 17, 2004.

[8] David C. John. **"Answering the Top 10 Myths About Social Security Reform"**. *Heritage Foundation.* November 4, 2002

[9] Peter Ferrera. **"Social Security Personal Accounts: A Progressive Proposal for Reform".** Institute for Policy Innovation*.* 2003.

[10] George W. Bush. **"A Defining American Promise"**. Speech to Rancho Cucamonga Senior Center. May 15, 2000

[11] The part of the savings that are converted into an annuity cannot be inherited. A retiree wanting to bequeath would have to buy life insurance.

[12] David C. John. Op. Cit.

[13] Since its inception the Social Security program has raised payroll taxes 24 times, about once every two years

[14] **"Fixing Social Security"**. Economic Policy Institute. 1999

[15] Martin Feldstein & Andrew Samwick. "Two Percent Personal Retirement Accounts", Working Paper No. 6540. **National Bureau of Economic Research**. 1998

[16] Bernard Wasow. ***Setting the Record Straight****.* The Century Foundation. March 2002

[17] "Fixing Social Security". Op. Cit.

[18] Some estimate it at less than 0.7%. See Dean Baker. **"Privatizing Social Security"**. *The Wall Street Fax.* July 1, 1996.

[19] Alicia H. Munnell. **"Just the Facts on Retirement Issues"**. Center for Retirement Research at Boston College. February 2003

[20] **"Facts About Retirement Income Security"**. Economic Policy Institute. 2000

[21] **"The Problems with Privatization"**. Economic Policy Institute. 2001.

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