

SOCIAL SECURITY PROGRAM

PRIVATIZATION

Merits and Drawbacks

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TABLE OF CONTENTS

<u>EXECUTIVE ABSTRACT</u>	1
<u>INTRODUCTION</u>	2
HISTORY	2
CURRENT FUNDING SOURCES	3
PROJECTED SHORTFALLS	4
<u>PRIVATIZATION</u>	5
OVERVIEW	5
MERITS	6
DRAWBACKS	7
ALTERNATIVES	8
<u>CONCLUSION</u>	9
<u>WORKS CONSULTED</u>	10

EXECUTIVE ABSTRACT

Social Security is the largest program managed by the Federal Government. During 2003, more than fifty million Americans received some type of benefit payment from the Social Security Administration (United States). It is very understandable how any changes to this program can produce an almost overwhelming amount of discussion. Considering the political ramifications that any changes to the program can generate it is miraculous that changes do occur. Both politicians and special interest groups agree that Social Security needs to change in order to function at its intended capacity through the next seventy-five years. The retirement of baby boomers and the reduction in the ratio of wage earners to retirees from 3/1 to 2/1 will create a shortfall. The points that the interested parties disagree upon is when the shortfall will occur and how much it will be. The President is proposing a plan as outlined in a report from the bipartisan *Committee to Strengthen Social Security* (CSSS). As described in the Committee's report, the plan calls for the addition of voluntary personal accounts, more commonly referred to as privatization, to be added to the Social Security program. The idea does have some merits; however, reports from leading financial, economic and special interest groups point out significant drawbacks. Some of these drawbacks include the volatility of the stock market and the estimated actuarial statistics used to support the report's findings. Experts have proposed alternative solutions some of which include:

- Raising the income cap
- Raising the retirement age to 68
- Increasing the FICA tax rate by one percent
- Reducing benefits slightly

The other point that most experts agree upon is that there is no immediate crisis. The problem does need to be addressed; however, it needs to be addressed in a manor that will cause the least burden to taxpayers, politicians and those who need the program the most, our aged and disabled Americans.

The President has done a commendable job in highlighting the need to make changes to the Social Security program. The plan he is proposing presents some very good merits like inheritable funds and the building of wealth. The drawbacks, unknown costs and volatile stock market, however, do seem to out weigh any potential merits.

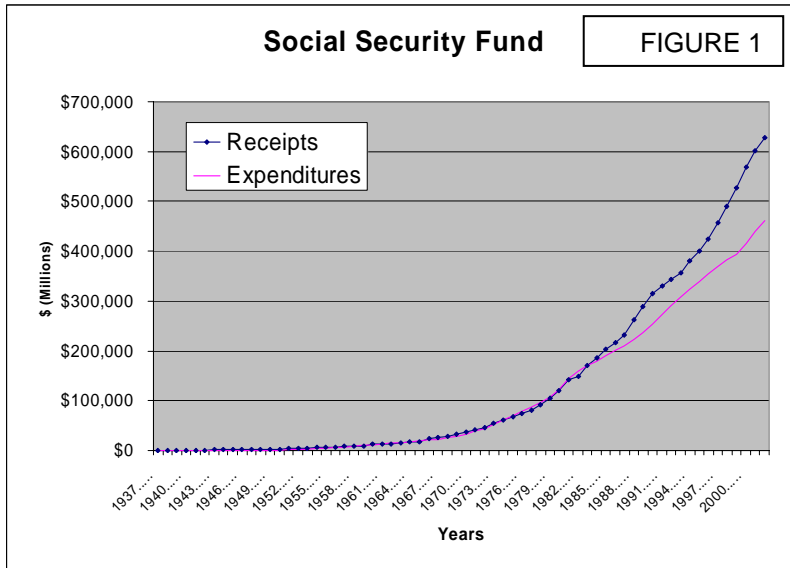
I have concluded through my research that the best long-term solution to funding Social Security would be a combination of these three items; raise the retirement age, raise the income cap for payroll taxes and raise the tax over a multi-year period.

INTRODUCTION

HISTORY

Social Security was signed into law by President Roosevelt in 1935 (United States). This was the first large scale federal insurance program of its kind and was in direct response to the economic devastation created by the stock market crash and the ensuing depression that wiped out the bulk of the savings accounts of older Americans. The program was expanded in 1956 to include disability benefits. Over the next fifty years, changes have been made as needed to keep the program inline with the changing economy.

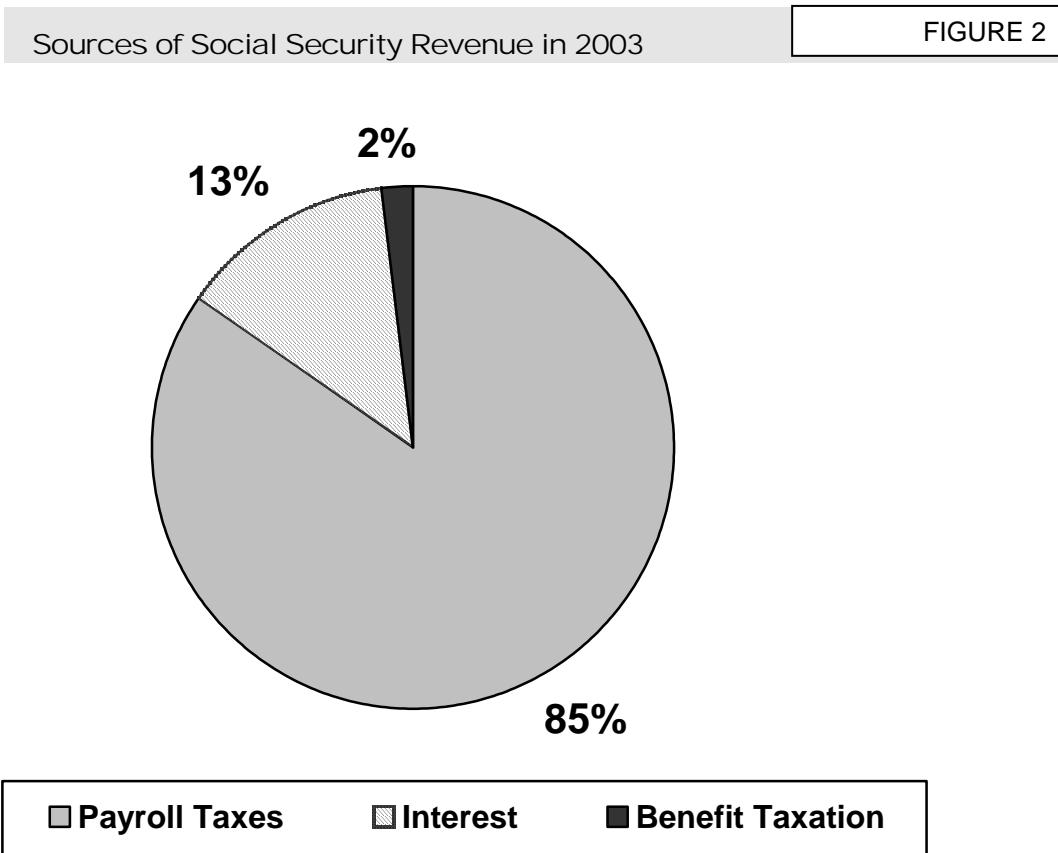
As shown in Figure 1, the receipts and expenditures have grown quite a bit over the years.



Source: United States. Social Security Administration.

CURRENT FUNDING SOURCES

The majority of the funding for the Social Security program is generated through the Federal Insurance Contribution Act (FICA). This act authorized the Internal Revenue Service to collect tax dollars from payroll to be applied to the Social Security Trust Fund. The current tax rate is 12.4% split evenly between employee and employer. Self-employed individuals pay the entire 12.4%. This tax is only collected on the first \$90,000 that is earned. As shown in Figure 2, the payroll taxes contribute the bulk of the funding. About 13% of the funding is generated from interest on government bonds owned by the trust and the remaining 2% from taxation on benefits received (United States).

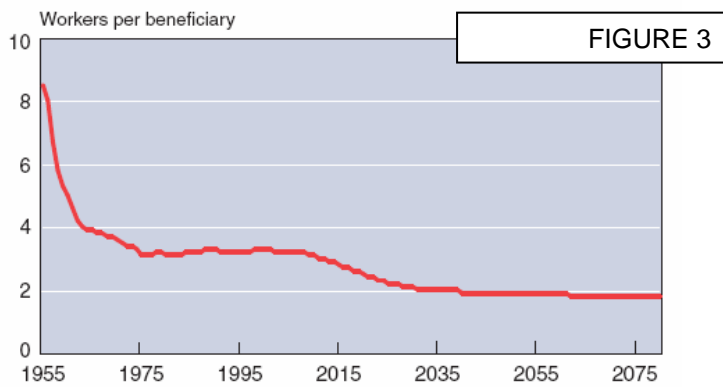


Source: United States. Social Security Administration.

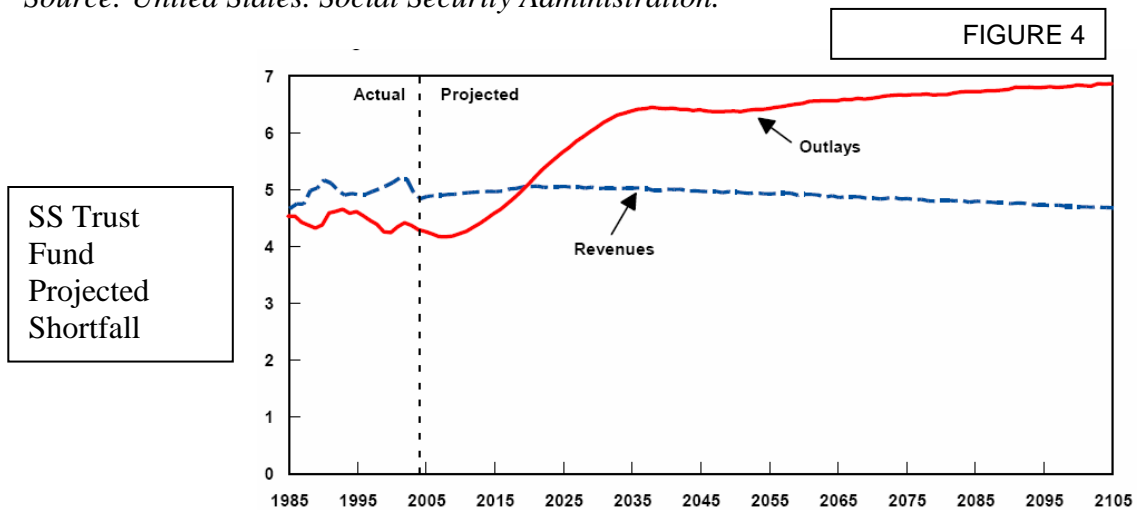
PROJECTED SHORTFALLS

The major hurdle that the Social Security program faces in the next decade is the retirement of the baby boomers. This will create a two-fold problem. The first problem is; the increased numbers of retirees will require additional expenditures secondly; as shown in Figure 3, is that there will be fewer workers contributing to the tax base. From 1955 to 1975, workers to retirees declined sharply and the program was adjusted from a contribution rate of 2% to almost 6% to compensate for the drop (United States). In 1983, legislators raised the retirement age, and increased the payroll taxes to help lessen the impact of the coming baby boomer bubble. This change helped to create the large surplus in the Social Security Trust Fund (United States). By 2031, the program will face an additional reduction from 3.3 workers to 2.1 workers (United States). As illustrated in Figure 4, this ratio reduction, along with a larger retirement population, will cause the expenditures to exceed revenues (United States. Congressional Budget Office.)

Ratio of covered workers to Social Security beneficiaries



Source: United States. Social Security Administration.



Source: United States. Congressional Budget Office.

PRIVATIZATION

OVERVIEW

Privatization is the common term being used for the addition of voluntary personal accounts to the Social Security program. The plan that President Bush has referred to in the media is *Reform Model 1 of Strengthening Social Security and Creating Personal Wealth for All Americans*, the final report of the President's Commission to Strengthen Social Security. The plan details the voluntary investment of 2% of the worker's wages into a personal account. The commission was under the direction of the President to meet several criteria, these included:

- Modernization must not change benefits for retirees.
- The Social Security surplus must be used for Social Security only.
- Payroll taxes must not be increased.
- The Government must not invest Social Security funds in the stock market.
- Changes must preserve benefits to disability and survivor recipients.
- Modernization must include individually controlled, voluntary personal retirement accounts.

In a speech to the Senate Banking Committee Federal Reserve Chairman Alan Greenspan, in reference to personal accounts, said; "a good thing to do over the long run" (Curry). Mr. Greenspan felt that the creation of what some would call a forced savings plan would create economic capital for millions of Americans. He felt that this would be good for low wage earners that typically do not have a personal retirement account.

MERITS

As outlined in *Reform Model 1 of Strengthening Social Security and Creating Personal Wealth for All Americans* there is a projected increase in benefits of 32% over what current retirees receive by the year 2032 (Commission to Strengthen Social Security). Having personal accounts would also make possible the creation of wealth for individuals by creating ownership (Curry). An additional key feature of the personal accounts is that they would be inheritable (Curry). In a recent speech to the Senate Banking Committee, Federal Reserve Chairman Alan Greenspan was quoted as saying; “When you have assets which you own, which you can bequeath to your children, (assets) which have your name on them, I think it is highly desirable thing, because you give wealth to people in lower- and middle-income groups who have not had it before” (Curry). This is a significant change. Currently the system only provides for a one-time payment of \$255 upon death (Commission to Strengthen Social Security). Wage earners would be able to direct their money that is held in personal accounts possibly generating a higher return than what would be normally seen from the existing Social Security program (Commission to Strengthen Social Security). Over longer periods, 20 to 30 years, the stock market has traditionally produced a moderate return on investments. Adding the provision for personal accounts would minimize the impact of the large population of baby boomers that are heading towards retirement age (Commission to Strengthen Social Security).

The President has emphasized that adding private accounts would not change the current benefit schedule for persons over the age of 55 (Reid). The President sees the proposed plan as a good for Social Security as a whole and a way to build equity for millions of Americans that they would own (Reid)

“I think every citizen, every citizen has got the capacity to manage his or her own money — and if they don’t, we’ll help them understand how to and the rules will be such that they can” (Reid).

President Bush Speaking at Press Conference

DRAWBACKS

There are some drawbacks to adding personal accounts to the Social Security program. As discussed in his report titled “Social Security Privatization: The Retirement Savings Gamble” Christian Weller, Chief Economist for the *Center for American Progress*, points out that there are inherent risks to investing in the stock market. There is the possibility that the stock market could experience a long period of below average returns (Weller). This could have a dramatic effect on a personal account if the owner was near retirement age and did not have the luxury of waiting out a slump (Weller). An additional drawback to adding personal accounts to the program are the transition costs. There is no clear estimate of what the total cost would be to setup and manage personal accounts, however, one expert has estimated the cost at nearly \$2 trillion over the first ten years (Scott). In my opinion, this uncertainty over the true transition costs and the volatility of the stock market are the major drawbacks to adding personal accounts to the Social Security program.

The President, leading experts, and special interest groups like AARP, all agree that something needs to be done in the near future to fix the long-term financing of Social Security (Wolk). The President has commented that he would not be opposed to looking at other plans “I’m interested in good ideas. People need to come forth with good ideas. The one thing I won’t do is negotiate with myself,” he said recently at a roundtable discussion with regional newspapers (Reid).

The plan needs to be not only fiscally sound, but it needs to have the solid backing of special interest groups like AARP. At this time, the plan as proposed does not meet either of those criteria (Goozner). The plan would take the risk away from the collective pool of the Social Security Administration and put it into the hands of the individual. While someone who is experienced at investing and has additional investments besides Social Security may be able to ride out a bad turn in the stock market. The average worker with no other investments would not (Goozner).

ALTERNATIVES

Adding private accounts is not the only option being discussed by leading financial and economic experts. In her article titled *Social Security Crisis? What Crisis?*, Laura D'Andrea Tyson explains that the problem with the funding Social Security can be fixed by a slight increase in payroll taxes from the current 12.4% to 13.2% in 2035 and 15.5% in 2075. This coupled with a modest cut in benefits over the same time period would keep the Social Security program solvent for the next several decades (Tyson).

Raise the Income Cap

An additional plan that has been discussed in several articles is the raising of the income cap for payroll tax purposes. Currently only the first \$90,000 of income is subject to Social Security payroll tax. This limit was set in 1983 to cover approximately 90% of wage earners. Today, \$90,000 is equal to about 84% of wage earners (Goozner). Based on the existing tax rate of 12.4%, raising the limit to \$140,000 would increase the annual tax collection by \$6,000 per wage earner in that income bracket. This amounts to roughly \$8 per day out of pocket change to the individual.

Raise Payroll taxes

The President would like to avoid this option. He said in a recent roundtable to regional newspapers, “The one thing I’m not open-minded about is raising the payroll tax rate. And all the other issues go on the table,” (Reid). However, some experts have stated that based on reports from the Social Security Trust fund, raising the tax rate by only 2% would keep the program funded through 2077 (Goozner).

Raise the Retirement Age

Raising the retirement age would effectively reduce benefits (Goozner). For every additional year that the retirement age is raised to, lowers the benefits paid out, and keeps the worker to retiree ratio at a higher level.

Universal 401(k)

Gene Sperling, an Economist for the Center for American Progress, outlined a plan in his report titled *A Progressive Framework for Social Security Reform* to create a “Universal 401(k).” His idea is to create a national 401(k) retirement savings account that would offer the same tax deferred status that many corporations already offer to their employees. He also suggests that the government could do a 2-to-1 match to a limit of \$2,000 for lower income workers and a 1-to-1 match for mid level income families.

CONCLUSION

Millions of Americans depend on Social Security checks each month to maintain their standard of living. Future retirees are entitled to the same benefits that current retirees enjoy. The system has worked since 1935, and there is no reason that it cannot continue to work as long as adjustments are made to deal with the mass retirement of the baby boom generation.

President Bush is doing the right thing in making Social Security a priority for his term in office. The plan that he has proposed may not be the best solution and it does appear that he is open to suggestions from other interested parties. The AARP will have a significant voice in the political discussions that are sure to continue over this hotly debated topic. It will take cooperation from both major political parties, as well as the special interest groups like AARP to create a workable long-term solution. I think that the two key points that most everyone can agree upon are that there is not immediate crisis and that something does need to be done to ensure the viability of the Social Security program for all future retirees.

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