Do The Right Thing

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Social Security is a mess. Contrary to the Social Security Administration's propaganda, there is no real trust fund. Roughly 90 percent of the payroll taxes collected from workers today are sent out immediately to current retirees. At times that figure has been almost 100 percent. Those who retired in the early '40s got huge benefits in return for paying low payroll taxes for a few years, but as the system has "matured," later retirees have received much lower returns. A private citizen who set up such a financial chain letter would go to prison. In fact, he did. Charles Ponzi was arrested in 1920 for promising investors that they could double their money in 90 days by using the proceeds of later participants to keep his commitments to earlier ones. Thus the term Ponzi scheme. There are only two real differences between Ponzi's original scam and the Social Security system. The first difference is that Social Security is run by government and is therefore legal. The second difference, which follows from the first, is that the government forces people to participate; Ponzi had to rely on voluntary suckers.

Going for broke

Soon after the baby boomers start to retire, Social Security benefits will exceed payroll taxes, forcing the Social Security Administration to redeem some of the government bonds in its trust fund. To free up the cash to pay for these bonds, the U.S. government will have to cut other government spending, increase taxes, or float new bonds to the public. No one can know for sure when this will happen. The Social Security Administration's official projection is that it will happen in 2012, but its projections on income versus outgo have been consistently optimistic. In 1983, the administration's board of trustees estimated that the fund would be solvent--that is, it would still hold some government bonds--until the year 2058. But in the last ten years, the board has shortened that projection eight times; now it thinks the system will be solvent until 2029. A good guess, therefore, is that outgo will start to exceed income well before 2012.

Government actuaries estimate that to maintain promised benefits, the tax rate would have to rise over the next 50 years from its current level of 12.4 percent to as much as 23 percent. And we haven't even mentioned Medicare, which will also require increasingly higher tax rates unless fundamental reforms are made. But total federal revenues from all sources, not just from the Social Security payroll tax, have stayed within a narrow range of 18 to 20 percent of gross domestic product for the last 40 years. So the chance of significantly raising the Social Security tax rate is fairly small, fortunately.

This means, necessarily, that at some point in the future, benefits will have to be less than promised. That doesn't mean that benefits must be cut, because built into the benefits formula are steady increases in real benefits as long as real wages rise. The average annual benefit per retiree in 1995, for example, was $7,510, and according to Harvard economist Martin Feldstein, if there is no change in the system, this average, in 1995 dollars, will be $8,790 in 2016 and $9,290 in 2023. But it does mean that the growth of benefits must be slowed substantially.

Redefine 'senior'

One possible adjustment is a gradual increase in the age at which you can receive Social Security. The current age for recipients is 65, but that number was set in the '30s. Back then, 65-year-old men could expect to live an extra 12 years, and 65-year-old women could expect to live an additional 13. Today those numbers are 15 and 19, respectively, and work for virtually everyone is much less physically demanding than it was then. The age for full receipt of Social Security benefits is already slated to rise to 66 in 2009 and 67 in 2027. But the age could be raised in stages to 70 by, say, 2015, giving people ample time to adjust their plans.
Other adjustments could be made. Social Security benefits are indexed to the consumer price index, which overstates inflation by roughly 1 percentage point a year. If the government started now to index to the CPI minus that 1 point, total benefits would grow less quickly and would ultimately be 9 percent lower, according to Mr. Feldstein. And the formula that sets future benefits could be changed so that real benefits stay the same. These changes taken together--raising the retirement age to 70, indexing benefits to a truer measure of inflation, and freezing real benefits--would eliminate the funding crisis and probably also allow some modest decreases in the Social Security tax rate early in the next century.

But even with all those changes, we would still be left with an intractable problem: a lousy rate of return--about 2 percent compared with, say, the 7 percent that could be earned with a long-term mutual fund indexed to the stock market. A fourth sensible adjustment, then, would be to end Social Security gradually. I advocate this not mainly because Social Security is such a bad deal, but also because government is not our parent. It simply has no business telling us how much we must save for our old age. It has even less business pooling our "savings" (taxes) with other people's taxes and then deciding how much we get back, based loosely on how much we pay in (don't earn too much), our income after we retire (don't save too much), our marital status (marry someone who didn't pay Social Security taxes), and our age (live long).

It's easy to see how a 30-year-old could do well if the government ended the payroll tax today and he or she invested even half that amount annually in the stock market. But remember that Social Security is a chain letter. If that 30-year-old doesn't pay Social Security taxes, who pays the benefits of current retirees and of those who will retire in the next 20 or 30 years? That's a huge transition problem for advocates of ending Social Security to address.

Learn to count, Steve Forbes

If the government substantially cuts payroll taxes for current workers, it must cut spending on other government programs by about $350 billion a year, cut the growth of benefits, sell government assets, or increase other taxes. In a recent Wall Street Journal editorial, Steve Forbes suggested that converting the Social Security Trust Fund's $500 billion "phantom IOUs" (his term) into real bonds "could help finance the transition over the next decade and a half." This raises two questions: Where does the money come from to redeem this $500 billion? And where do you get the other few trillion? Mr. Forbes's reasoning illustrates the power of innumeracy in helping ignore tough problems. Asset sales are an excellent idea, but their power should not be overstated. Pete Peterson, chairman of the Blackstone Group, a private investment bank, estimates that the federal government's assets are worth $2.3 trillion. The unfunded liabilities for Medicare and Social Security total $15.3 trillion.

Some people advocate privatizing Social Security--that is, requiring each person to invest annually in an individual retirement account. Advocates of privatization often point to Chile's relatively smooth transition to privatization in the early '80s. Let's look at Chile. Annual transition costs to pay current and future retirees amounted to about 5 percent of the country's GDP throughout the '80s, which is comparable to what it would be in the United States. To handle the outlay, the Chilean government started with a budget surplus of about 5 percent of GDP. The United States is not in that position. Here, we're proud to have a deficit of less than 2 percent of our GDP.

My purpose in raising these issues is not to attack the idea of ending Social Security but to point out that it's irresponsible to discount the very large transition difficulties in doing so. I would end Social Security by freezing real benefits, raising the retirement age, cutting other government spending, and selling government assets. If these four methods were used extensively, the government could cut payroll taxes by a few percentage points. To end the program, the government could announce that no one currently under age 30 would ever be eligible to collect and could cut payroll taxes for those under 30 by a few additional percentage points. If polling data are to be believed, 70 percent of Generation X think that Social Security will not exist when they retire. That means that 70 percent already think they're paying taxes for nothing in return. My proposal confirms their suspicion and cuts their tax rate.

Absent a government program of Social Security, would people save for their own retirement? Many are skeptical because those on the verge of retirement save so little. In 1991, for example, the median financial assets of households with heads aged 55 to 64 were only $8,300, and the median net worth, including property values, for all households headed by someone under age 65 was only $28,000. But Social Security is one of the main things causing so many people not to save. As Mr. Feldstein has pointed out, someone with average earnings over a lifetime who retires at age 65 and has a "dependent" spouse receives benefits equal to 63 percent of his or her earnings the year before retirement. Since such a person's Social Security benefits are not taxed, this is equivalent to about 80 percent of preretirement net-of-tax income. If you think Social Security will provide for your retirement, why bother saving? Also, the tax and welfare system and the private and government criteria used to qualify people for college scholarships in many ways penalize saving. If you save too much, you won't get much help with your child's college tuition. If you save too much, you won't qualify for Medicaid spending on your nursing home care when you're old. If you save too much, your Social Security benefits will be taxed.

Let's call the whole thing off

The U.S. government's policies are not just hinting that you should save little; they're announcing it with a megaphone. With Social Security gone, the government's antisaving bias would be moderated.

When Franklin Roosevelt pushed through his Social Security payroll tax in the '30s, he planned for the taxes to "give the contributors [sic] a legal, moral, and political right to collect their pensions," he said. "With those taxes in place, no damn politician will ever scrap my Social Security program." That Machiavellian man was certainly prescient. Let's hope he wasn't right.