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SOCIAL SECURITY IS NOT IN "CRISIS"

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Click here for the December 2005 version of the talk. It was originally published by National Jobs for All Coalition, New York, NY, February 1999. That earlier text follows. How has Dick's thinking changed?

By any standard, Social Security is the most successful social program ever enacted in the United States, guaranteeing a measure of basic security for nearly all workers and their families. For two-thirds of the elderly, Social Security provides at least half their total income; for a third of them, it provides more than 90 percent. Without it, the poverty rate for the elderly would jump from 12 to 54 percent. But Social Security is not just for retirees: it also provides monthly benefits for disabled workers and their dependents, and for the dependents of deceased workers. Together, these two groups comprise 30 percent of all Social Security recipients.

Since its enactment in 1935, Social Security has also been America's most popular social program, and surveys show continued support. So why do more than half of young people think that Social Security will not be there when they retire? And why do so many people believe that the current Social Security system will be "bankrupt" when the baby boomers retire?

Despite its record, Social Security has always had opponents, who decry "big government" programs and have now created a sense of crisis to try to destroy a successful one. Much of the fear has been stirred up by a stream of scary articles and editorials in the major media, as well as by loud alarms from politicians, warning the younger generation that before they retire Social Security will already be hurtling toward insolvency.

The assumptions of impending Social Security "crisis" purport to be based on an economic reality--the aging of the population as baby boomers retire and as all retirees live longer. A falling share of the population who are still working will have to support growing numbers of elderly, whose retirement benefits could exhaust the Social Security Trust Fund and leave nothing for generations that follow. The conclusion appears unavoidable: without huge increases in tax rates, there will be a ballooning deficit in the funds from which Social Security payments are made. The only solution, we are told, is to allow workers to channel their payroll taxes into their own investment accounts. This would create a bonanza of new business for Wall Street, where returns are historically higher than for government bonds that are the only assets that the Social Security Trust Fund can hold.

A serious examination of these assumptions is in order: Will there be too many elderly for the working-age population to support? Can we afford the retirement bill? Is privatizing Social Security the answer?

Too Many Elderly for the Working-age Population to Support?

The economic burden of supporting retirees is often estimated by what is called the "dependency ratio"--the number of elderly compared to the number of people of working age (20 to 64 years). This ratio is projected to rise from 21.6 seniors per 100 working-age people in 1995 to 35.5 seniors in 2030, as Americans aged 65 and over increase from 34 million to around 70 million--and from 13 to 20 percent of the population. Thus, as the post-World War II baby boom generation reaches retirement age starting in 2012, it must be supported by the relatively smaller cohort of workers born during the low birth-rate years of the past three to four decades.

The problem here is that the working population supports *all* those who do not work--children (including students) as well as the elderly. This "total dependency ratio" changes the picture radically: the ratio of all dependents to workers is projected to rise from 71.1 per 100 workers in 1995 to 80.0 by 2030 and 84.6 in 2075. Not only does this represent a much lower rate of dependency growth than when only the elderly are included; it also reveals that *total dependency at its estimated future peak will still be well below what it was from 1960 to 1975*, when it averaged *dependency at its estimated future peak will still be well below what it was from 1960 to 1975,* when it averaged 89.4 percent of those working and peaked at 94.7 percent in 1965. No demographic projection for the next 75 years puts the ratio anywhere near as high as it was in the 1960s; only "a mortality revolution at the oldest ages" could possibly do that, observes the eminent demographer Richard Easterlin.

Total dependency ratios are anything but irrelevant. In the United States, the costs of educating the baby boomers caused large, probably unprecedented, increases in spending on education following the Second World War. At that time, our economic productivity was far less than today's. In real (price-corrected) terms, gross domestic product (GDP) per capita in 1960 was only 40 percent of what it was in 2000, and much less than what it will be in the next century. This means that one worker today can produce far more than the same worker did four decades ago, and less than what his or her successor will be able to produce decades from now. It seems safe to say that if we could afford to pay for the education of the baby boomers, we can afford to pay for their retirement.

As a fraction of GDP, spending by state and local governments on education grew from 1.5 percent in 1946 to 5.6 percent in 1975--which understates the actual increase because it excludes outlays by households on private education (independent and parochial schools and private colleges and universities). This increase of more than 4 percentage points of the GDP is nearly double the projected increase for Social Security over the next 75 years. Now education spending is on the rise again, as children of the baby boomers and immigrants pack America's schools. In 1997 enrollment at secondary school level surpassed its 1971 baby-boom peak, reached a record 53 million students in 2000, and, unlike the fall in school enrollment in the 1970s when the baby boom ended, is expected to grow without letup through the rest of the 21st century. Already public school systems face spiraling costs because of teacher shortages and aging, inadequate school buildings and equipment. Why are the doomsday prophets of Social Security silent on this matter?

Can We Afford the Retirement Bill?

Ultimately, our ability to support the dependent population hinges on two issues: Will our economy be able to produce the goods and services those people require? And will the government be able to finance its pension and other commitments? When the Social Security Act was passed in 1935, Congress specified that it was to be financed by a special payroll tax (now called FICA) on workers and their employers. This was done to muster political support; it was not an economic necessity. President Franklin Roosevelt favored such a payroll tax because he felt it would assure Americans that they had "earned" their benefits and had a right to them, and "with those taxes in there, no damn politician can ever scrap my Social Security program."

The economic fact is that no matter how pensions are financed, *the goods and services to be consumed by retirees cannot be stored up in advance but must be produced at the time:* the bread eaten in the future will be baked then, and the doctors and nurses who provide medical care must be available then. These goods and services will come from the nation's economic output, not from the money in the Social Security Trust Fund. If our output fails to grow, future consumption by retirees will cut more deeply into the goods and services available to the working population, whether that population is taxed to pay the retirement benefits or those benefits are paid from some accumulated trust fund, public or private.

Clearly, any forecast of the viability of Social Security, which is simply another claim on the economy's resources and production, must be based on how large the labor force will be and how high the productivity of its workers will be--in other words, on how fast the economy is predicted to grow in future decades.

The "Crisis" Projections: How Reliable?

To estimate the future condition of the Social Security Trust Fund over periods ranging up to 75 years, as they are required to do, the Social Security Trustees must make assumptions about the growth of the economy (GDP), wage income, unemployment, productivity, fertility, net immigration, mortality, marriage, divorce, disability incidence, and retirement patterns. It can readily be seen how each of these variables affects either the number of people working and paying FICA taxes or the number of retirees and disabled drawing Social Security benefits, or both (wage income and unemployment, for example, determine FICA revenues flowing into the Trust Fund and also the credits earned by current workers toward their future retirement benefits.) Because of the uncertainties associated with all these by current workers toward their future retirement benefits.) Because of the uncertainties associated with all these variables, the Trustees offer three "alternative" projections, based on three sets of economic and demographic assumptions, to show the range of possible outcomes--the "low-cost" or optimistic projection, the "high-cost" projection, and the "intermediate" alternative that the Trustees call their "best estimate of the future."

In recent years the Trustees' "best estimate" or intermediate alternative has been based on pessimistic assumptions about the most important variable for the future of Social Security--the rate of economic growth, which is the major determinant of employment and unemployment, as well as taxable wage income. Their low-cost or "optimistic" projection is only slightly less pessimistic. Both assume that in future years real GDP will grow much more slowly than it has over most of the past century or more, when it has averaged around 3 percent per year. In the intermediate alternative, growth rates over the next three decades average 2.0 percent per year, only 1.6 percent per year from 2030 to 2075. If the economy manages to grow at a 2.5 percent rate over the next 30 to 75 years, as the Trustees' "optimistic" alternative projects, the Social Security deficit will vanish. Yet even the relatively sluggish economy of the 1980s and 1990s (at least until the last three years of the 1990s) produced an annual growth rate of 2.8 percent. And just three years of faster growth and lower unemployment from 1997 through 1999 increased FICA tax revenues enough to push back the date by which the Social Security Trust Funds are predicted to be "exhausted," from 2029 to 2037. At that time, however, annual tax revenues are still estimated to be sufficient to cover 72 percent of annual expenditures.

If we nonetheless accept the Trustees' intermediate alternative, how large are the deficits predicted for Social Security starting in 2025? The Trustees measure them by calculating the immediate and permanent increase in the Social Security payroll tax needed to eliminate the deficits and establish "actuarial balance" for the Trust Fund over the next 75 years. At present, the FICA tax of 12.4 percent would have to be raised to 14.3 percent--or by slightly less than 1 percent on both workers and employers (who now pay 6.2 percent each on the first $80,400 of earned income).

The tax increase required by the intermediate alternative hardly seems onerous for a rich nation whose taxes are the smallest share of GDP of any high-income country. Nor is it necessary to increase the Social Security tax rate on low-wage workers. More than half of the actuarial gap could be closed by removing the income ceiling on the payroll tax ($80,400 in 2001) and imposing it on all incomes with no upper limit. This has much to recommend it, in view of the sharp increases in inequality of income and wealth in the United States since the 1970s. The point has not been lost on the Social Security Trustees: one problem, they report, is that since 1984, the ratio of taxable earnings to total earnings in covered employment has been declining "due to the increasing proportion of total covered wages earned by very high wage earners." An even better approach would be to restore more progressivity to the personal income tax and use it to help Social Security. The editors of *Business Week*, who have called the Trustees' intermediate estimate of future GDP growth "a ridiculously low number," also suggest that "using future general revenues to finance Social Security solves most of the 'crisis'" (*BW*, February 1, 1999).

The Trustees' "optimistic" or low-cost alternative does not produce any deficits, so no tax changes are needed. This holds true, it should be noted, even under the "optimistic" assumption that from 2000 to 2075 population will grow at the annual rate of 0.7 percent--less than it did during the Depression years 1929 to 1941. If, as seems likely, population, and numbers of workers contributing to Social Security, grow faster than this scenario would have it, there could be very large surpluses in the Trust Fund--one more reason to dismiss talk of a Social Security "crisis."

Is Privatizing Social Security the Answer?

Those who recommend privatizing Social Security would redirect workers' payroll taxes into personal retirement accounts to be invested in private financial markets. Free markets, the argument goes, are more efficient than government in handling pension funds, and they promise higher rates of return for investors.

But private investment vehicles cannot duplicate the efficiencies and benefits of a government-run insurance system, which is *universal*: it includes all workers rich and poor, well and unwell, and spreads risk across income classes and generations. Social Security covers major contingencies of life, is portable from one job to the next, and is financed by contributions that are not directly related to benefits. Because it is weighted in favor of workers with lower lifetime earnings, it keeps millions of elderly out of poverty. It is also an inflation-adjusted, lifetime benefit, guaranteeing that recipients will not outlive their savings.

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The private insurance system, by contrast, is becoming less reliable, and more expensive, for most Americans. Only one-third of private-sector retirees are receiving monthly pensions, and only a third are participating in traditional pension and profit-sharing plans. Fewer than one in three private-sector pensioners have ever received a cost-of-living increase. In these plans, retirement incomes are not guaranteed in advance ("defined benefit") but depend upon the investment skills of individuals and the performance of financial markets, as well as lifetime earnings ("defined contribution," or 401[k]-type plans). These are precisely the forces that have been reducing the proportion of the U.S. workforce covered by private pensions. The New York Federal Reserve Bank reported in 1998 that 35 percent of workers do not participate in any 401(k) plans, and that nearly half of all workers who had a 401(k) in a previous job took a lump sum distribution before retirement age. Only 28 percent rolled their 401(k) over into another tax-qualified plan. The same pressures would soon be brought to bear on individually-owned Social Security accounts; after all, they would be private property, and many Americans would no longer tolerate government telling them how to dispose of these accounts.

The failures of the private insurance market are more striking when the full range of insurance provided by the Social Security system is taken into account--something that privatizers refuse to acknowledge. Social Security provides not only retirement benefits, but also disability coverage and benefits to survivors of workers who die before retirement. For workers, the chances of becoming disabled or dying before age 65 are four in ten. The only disability insurance for three-quarters of all workers comes from Social Security. In a typical example, for a 27-year-old couple working at average wages, with two small children, disability protection is estimated to be equivalent to a $230,000 policy in the private sector. A comparable survivor policy is worth $338,000.

Privatization advocates claim, accurately, that over the past century the inflation-adjusted rate of return to stocks has averaged around 7 percent per year, and that for most future retirees the return on their FICA contributions will be less than half as much. But it is also an axiom of economics that higher returns are attached to investments that pose greater risks. Thus, the returns to Social Security should be lower because it is essentially a riskless security in a taxpayer's portfolio. Privatization would also face all of us with much higher administrative expenses and management fees, as well as unwanted risks--especially below average returns to stocks over periods long enough to erode incomes during retirement.

Despite the great stock market boom of 1982-1999, equities are not predestined to go ever higher and sometimes, for years on end, they don't. While returns to stocks may have averaged 7 percent over the long run, there have been several 20-year periods during which returns have been much lower, even negative. Proponents of privatization state that the long-term return on U.S. government bonds, seen as a proxy for Social Security, is around 2.5 percent per year. But between 1900 and 1998, there were 22 twenty-year periods during which annual returns to stocks were less than 2.5 percent. For example, someone who purchased a representative group of stocks in 1929 and held them for 20 years would have had annual returns averaging -0.2 percent by 1949; for someone holding stocks from 1965 to 1985, returns would have averaged 0.7 percent. These returns are calculated on the conservative assumption that management fees averaged 1 percent per year; any higher fees would have lowered returns and made this historical record for stocks look even less favorable.

Twenty-year durations are significant because most peoples' saving for retirement is done in the last 15 or 20 years of their working lives. Thus, someone who invested in stocks then retired during one of the down periods stood a good chance of ending up with meager gains in inflation-adjusted terms, or outright losses, just when they needed their savings to live on. Others lucky enough to retire during better times could have had gains as great as 10 percent per year, which was true for 9 twenty-year periods between 1900 and 1998.

Even over earning-and-saving periods longer than 20 years the same risks are present. For the period 1871 to 1997, Brookings Institution economist Gary Burtless calculated returns for workers who began to work at age 22 and retired at 62. Each worker saved 6 percent of his wages annually, invested it in a "total stock market index" fund, and at retirement converted the balance into an annuity. Burtless found that the amounts that workers could expect at retirement differed dramatically--timing was nearly everything. A worker who retired in 1969 would have been able to convert his proceeds into an annuity providing 104 percent of his former annual earnings; a worker retiring just six years later would have replaced only 39 percent of his prior earnings.

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Another insight into the risks of owning stocks over anything less than the long run--whatever that might turn out to be--comes from the period 1966 to 1981, which brought an unrelenting bear market and negative returns to most stockholders. The Dow Jones reached 995 in February 1966, spent most of the next 15 years below that level, and never surpassed 1052 until November 1982, while the inflation rate was escalating dramatically during these years. The only reason stocks have reestablished their 7 percent average return is nothing less than the subsequent bull market, the greatest in history. Wharton School Professor Jeremy Siegel, author of *Stocks for the Long Run* (1998), notes that "the superior equity returns" of the past 16 years have "barely compensated investors for the dreadful stock returns realized in the previous 15 years, from 1966-1981, when the real rate of return was -0.4 percent. In fact, during the 15-year period that preceded the current bull market, stock returns were more *below* their historical average than they have been above their average during the past 16 years."

Those who predict continued, higher long-term returns to stock ownership as a reason for privatization have another problem to grapple with. Can anyone believe that if future returns to Social Security are adversely affected by slower economic growth, returns to financial assets would not be? If the Social Security system runs higher deficits because of the slower economic growth that the Trustees' intermediate alternative assumes, it is illusory to think that returns to stocks will fare any better. Stocks have produced real returns of 7 percent per year over the past century when the economy averaged 3 percent annual growth. If the intermediate-range projections for GDP growth hold true, the rate of return on capital will be less too. If the economy grows at a faster rate, the stock market will rise at a healthy pace--but Social Security will also have the funds it needs to keep solvent throughout the retirement of the baby boom generation.

At present, the average American has more exposure to equity markets than at any time in our history. It would appear to be more than adequate. Americans would do well to recall that Britain allowed workers to opt out of the public pension system and invest in private accounts in the late 1980s and early 1990s. Soon, many were hurt by bad advice and outright scams in what was dubbed the "pension mis-selling" scandal. By 1998 it had already cost insurers some $18 billion in compensation payments, and final resolution of the mess was expected to take years.

Social Security's "Bottom Line"

"Rate of return" calculations for Social Security, and projections of possible "bankruptcy" inappropriately apply free market criteria to a nonmarket institution, in this case the most successful one in our history. Comparing returns on FICA contributions for one generation of Social Security beneficiaries against another, or calculating "unfunded liabilities" that the present generation will allegedly pass on to the next, is irrelevant, unless it is assumed that succeeding generations will live in an economy less productive, and poorer, than today's--an unlikely prospect. Pooling resources so that everyone shares the major risks of life is the essence of social insurance, allowing people to make transfer payments to themselves at appropriate stages of the life cycle. Social Security is part of this public-sector process, which, in a free market economy, is the means of last resort for sustaining us as a collection of diverse human beings with different fates, but common basic needs.

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