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Social Security: Past, Present and Future

by Sylvester J. Schieber

Summary

Today, concerns over the size of Social Security focus on the intrusion of payroll tax rates on workers' ability to save for retirement. Concerns for the future relate to returns young workers will get on their payroll tax rates. The earliest architects of the system warned that shifting from advance funding to pay-as-you-go financing would yield problematic rates of return for future generations.

In a retirement context, Social Security insures against two risks: (1) a work career of modest earnings; and (2) workers' myopia in saving for their own retirement. Rates of return calculations are misleading for the first risk because it has no private market counterpart. The value of this protection must be decided in the courts of public opinion through the political process. But rates of return calculations are very important for the second risk. We need a Social Security solution that gives people a greater sense of security and fairness than seems to prevail today.

There is a question of relative sizing of our existing national defined benefit retirement system that is worthy of public discussion. I believe that there are indications—some of them historical, some of them current, and some of them forward looking—that suggest our Social Security system is larger than a lot of people would like.

The Size of Social Security

Economists have observed that the tax incentives encouraging home mortgages and employer-sponsored health benefit plans have led to potentially excessive direction of our national resources to housing and health care. I believe a similar argument could be made that the significant subsidization of Social Security benefits during its implementation probably encouraged it to grow larger than it would have otherwise and possibly larger than is desirable.

While Social Security was relatively redistributional even during its early days, the absolute subsidization of retirement income was much larger for middle- and upper-income workers than it was for those with a career of low earnings. The program was such a good deal in its early years that workers had to have been enthralled with their significant windfalls. It is unlikely that they fully appreciated the burden they were creating for future generations.

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Certainly, larger employers of the day who were creating their own retirement plans to manage work forces had to have understood the tremendous windfall presented them because they had trained actuaries helping to integrate the systems.

During the late 1940s, those concerned about the tendency for the tremendous deal to stimulate public demand for more of the same advocated a two-tier system with immediate provision of benefits for all the elderly. They thought the cost rate of a fully implemented system would act as a governor on benefit demands. These proposals were never successful, and the system as we know it today did not mature until the mid-1970s, the point when the portion of the population over 65 receiving benefits reached equality with the portion of the work force paying taxes.

Today, concerns over the size of the program are expressed through observations about the relative magnitude of payroll taxes and income taxes that workers pay, about the intrusion of payroll tax rates on rank-and-file workers' ability to save for their own retirement needs, and on the overall deadweight burden on economic activities.

For the future, there are dual concerns about the expansion of tax rates that many people already find onerous and about whether or not the system is a fair deal for today's younger workers and future generations. The question of whether young workers get a fair return on their Social Security taxes seems to be on many people's minds.

Privatization, Prefunding and Rates of Return

I agree wholeheartedly with the findings of Geanakoplos, Mitchell, Zeldes[1] that privatization and prefunding are distinct and need to be evaluated as such. "Privatization" — that is, the creation of individual defined contribution accounts as part of Social Security — is quite separate from "prefunding" — that is, building up more advance funding in the system. I agree that privatization without prefunding will not raise the rate of return on the current system; and that it is prefunding, itself, that raises rates of return on Social Security taxes. I also agree that prefunding cannot be achieved without incurring costs and that the assignment of those costs will affect the overall rates of returns differentially for various generations. Despite the costs associated with it, I am driven to the conclusion that we would be better off with some prefunding. Further, I am of the opinion that a central government entity like Social Security will never be an accumulator of private assets. I come to this conclusions based partly on my reading of the history of the current system, which was originally intended to be partially funded, and based also on my perceptions about the role of the central government in our society.

Lessons from History

I am not the first to come to this conclusion. Indeed, the earliest architects of the program recognized the relationship between prefunding and rates of return for future generations. As evidence, I offer an observation from Arthur Altmeyer, "Mr. Social Security" during the early years of the program. Of the *de facto* decision to move the program from its originally intended partial prefunding basis to a pay-as-you-go basis, he testified:

> The indefinite continuation of the present contribution rate will eventually necessitate raising the employees' contribution rate later to a point where future beneficiaries will be obliged to

> pay more for their benefits than if they obtained this insurance from a private insurance company.
>
> I say it is inequitable to compel them to pay more under this system than they would have to pay to a private insurance company, and I think that Congress would be confronted with that embarrassing situation.[2]

Anticipated rates of return provided by Social Security for future cohorts of retirees are problematic. They are likely to generate increasingly negative assessments of the program, further undermining the faith of the American public in it. This is not an ideological conclusion; it follows from the common sense assessment of Arthur Altmeyer back in 1945. His point merits serious consideration.

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When the Committee on Economic Security reported to Congress, Franklin Roosevelt said the goal of its recommendations was to protect workers against "certain hazards and vicissitudes of life." Of the hazards and vicissitudes of life that Social Security covers, the greatest concern over money's worth arises under the Old Age Insurance program. The reason for this relates to the accrual of "wealth" in the form of Social Security benefits during workers' careers and the implied rate of return on that wealth accumulation. The problem Social Security faces is that its ultimate rate of return is limited to the combined rates of growth in wages and the labor force. In a world with slow growth rates in both of these items, cohort-specific returns are bound to be paltry.

The Two Risks Insured Against

Part of the concern about Social Security's returns relates to the hazards that are being "insured" by the retirement program. I believe there are two separate "hazards" being covered by the retirement program. Their muddling has led to significant criticism of the program from a money's worth perspective. One of the hazards is the risk of an unsuccessful work career. The other is the risk of workers' myopia in regard to saving for retirement during their working career. The insurance to cover these two risks raises widely different implications about the importance of Social Security rates of return.

Some workers have low wages over their whole work careers and cannot save adequately for their retirement. Others face circumstances at some point in their lives that significantly derail their ability to save. Such problems diminish workers' ability to save on their own, and a redistributive social insurance program can help to ameliorate the situation. Private insurance institutions do not provide insurance of this sort.

Insuring against workers' myopia relative to their own need to save for retirement is completely different than insuring them against career breakdowns. In insuring against the problem of savings myopia, the requirement that workers make some provision for their own retirement needs can be achieved through Social Security, as we do now, or by requiring that workers save for retirement through some alternative vehicle.

Current money's worth calculations for the "bad labor market experience" element of

Social Security may be misleading because there is no private market counterpart against which the program's operations can be measured. This part of the program provides insurance with similarities to home fire insurance. Just because a homeowner can not make a claim on insurance because there has not been a fire doesn't mean the homeowner has not received value from the insurance. Just because a worker experiences a full successful career does not mean that he or she does not derive some value from insurance against a bad career outcome. There is insurance value in the protection against the contingency of career breakdown even though none occurs in some cases. This value is not recognized in current money's worth analyses.

The difference between insurance against bad labor market experience and home fire insurance is that the latter has a determinable value based on the probability of a fire and the property value being insured. In the case of insuring people against career failure, the actuarial determination of value that can be made on homeowner's fire insurance must be replaced by a social valuation determined in the courts of public opinion and political deliberation. To determine whether the "bad labor market experience" element of the program is providing money's worth, policymakers must weigh program costs against perceived benefits to society. This inexact process is driven by political considerations about relative needs of retirees versus other things that compete for governmental resources.

Relative rates of return to the mandated retirement savings portion of our Social Security system are extremely important. Once again, the reason relates to the point that Arthur Altmeyer made in his 1945 congressional testimony cited earlier. Simply put, it is unfair to compel workers to pay more under this system than they would have to pay under a private alternative. The current system has not been an effective capital accumulation vehicle because of the realities of the legislative process. The original architects of Social Security knew that the failure to fund the program would have dire implications for future workers when the system matured. Because of the inability to fund the program during its early years, Social Security is unfair to many current workers according to the criteria its architects specified, and it will become increasingly unfair for future worker cohorts.

Just because a worker has a successful work career does not mean that he or she had no value from insurance against a bad career outcome. That value is not recognized in current money's worth analysis.

If we were to create some form of individual accounts as an element of Social Security reform, it would introduce a different element of risk than exists in the current system. Some kinds of risks, such as equitable treatment of spouses and divorced spouses, could be accommodated in a system of individual accounts.[3] In some regards, earnings sharing, or more precisely, retirement accrual sharing, could be achieved more readily under an individual account program than under the current system. If husbands and wives are not inclined to properly make provision for dependent spouses through voluntary joint and survivor provisions, there would be nothing to prevent policy makers from mandating joint and survivor benefits for married couples.

Conclusion

It is fairly clear to me that no matter what we do to reform the current system, we cannot eliminate all of the risks that workers and retirees will face in the future. But Franklin D. Roosevelt acknowledged this problem in his presidential statement at the signing of the Social Security Act in 1935 when he said: "We can never insure 100 percent of the population against 100 percent of the hazards and vicissitudes of life." That is as true today as it was then. But the certainty is that we must do something. The practical fact is that we would be better off doing something sooner rather than later. The hope I have is that we can find a solution that will give people a greater sense of security and fairness relative to Social Security than seems to prevail across large segments of the work force today.

Endnotes

1. Geanakoplos, John, Olivia Mitchell and Stephen P. Zeldes, (1998). "Would a Privatized Social Security System Really Pay a Higher Rate of Return," *Framing the Social Security Debate: Values, Politics and Economics*, R. D. Arnold, M. Graetz, and A. Munnell, eds., National Academy of Social Insurance, The Brookings Institution Press, pp. 137-156.

2. I.S. Falk, "Questions and Answers on Financing of Old-Age and Survivors Insurance," memorandum to O.C. Pogge, Director, Bureau of Old-Age and Survivors Insurance, February 9, 1945, p. 16.

3. Holden, Karen C. and Cathleen Zick, (1998). "Insuring against the Consequences of Widowhood in a Reformed Social Security System," *Framing the Social Security Debate: Values, Politics and Economics*, R. D. Arnold, M. Graetz, and A. Munnell, eds., National Academy of Social Insurance, Brookings Institution Press, pp. 157-169.

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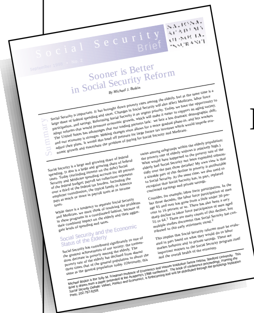

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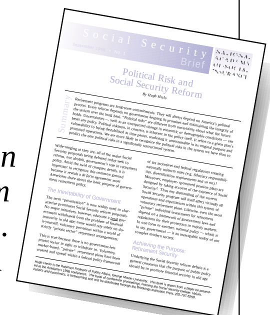

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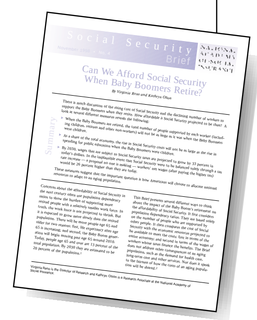

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