

# ECONOMIC COMMENTARY

Federal Reserve Bank of Cleveland

## Should Social Security Be Privatized?

by Jagadeesh Gokhale

Many developed countries operate comprehensive public pension programs to protect the elderly against a wide range of adverse economic circumstances. In the United States, the Social Security program has been in operation for 60 years and has expanded over time in terms of both payroll tax rates and per capita benefits. The manner in which such programs are financed and the methods used to provide retirement and other benefits exert a significant influence on national saving, the labor supply, and ultimately, economic growth.

Because a sizable chunk of the U.S. population is expected to begin retiring relatively soon, the rationale, operation, and magnitude of the Social Security system are likely to come under increasingly intense scrutiny by policymakers and the public alike.<sup>1</sup> Several interest groups are advocating a downsizing of the system, and the Commission for the Reform of Entitlements, appointed by President Clinton, recently recommended that a portion of Social Security be privatized.

Reforms of public pension systems have been implemented or are being contemplated in several nations. The reform effort in Chile, which moved the country toward privatization in the early 1980s, has been hailed as an unequivocal success because it transformed a system headed for bankruptcy into one with significant reserves and the capacity to provide retirement benefits at high rates of replacement.<sup>2</sup> Argentina, Australia, Bolivia, Columbia, the United Kingdom, and Peru may soon follow suit. This *Economic Commentary* takes a brief look at

the rationale for public pension programs, discusses the evolution of the U.S. Social Security system, and examines the issue of privatization.

### ■ Rationales for Public Funding

There are three main rationales for public intervention in retirement funding. The primary concern is that a large fraction of the population will not save and insure adequately during their high-earning years and thus will arrive at retirement in poverty. Both high and low earners could end up with insufficient resources because of a lack of foresight about their future needs, an intense desire for current consumption despite an appreciation of future needs, or misinformation about future earning prospects and disability/mortality probabilities.

Because of the uncertainty surrounding one's longevity, it makes sense to invest retirement savings in annuities that provide a steady income until death. Hence, a second rationale for public intervention is that the private market for annuities is thin or that annuities are priced unfairly because of informational problems. Anyone offering actuarially fair annuities would attract only relatively healthy individuals with very low mortality probabilities, thus making actuarially fair pricing unprofitable. This kind of informational problem also affects private disability, spousal, and survivor insurance. A government, however, can overcome this problem by mandating universal coverage through a retirement insurance program that pays benefits in the form of annuities — like the Social Security System in the United States.

The challenge of providing income security for a growing number of retirees promises to place Social Security reform at the center of future economic debates. Although the system is projected to be solvent over the next three-and-a-half decades, its current and prospective transactions with the general government budget make it an integral part of the nation's overall fiscal policy. Hence, judging its solvency independently may prove misleading.

The third major rationale for public pension support is that it is impossible for the private market to provide mechanisms for risk-sharing between living and unborn generations. If one generation suffers through a war or a severe economic depression, there is no way for private insurers to spread any of the costs of these events to future generations. But the government can do so by providing benefits to the unfortunate generations today and by deferring taxation so that future citizens are required to pick up part of the tab.

### ■ Evolution of the U.S. Social Security System

The initial impetus for setting up the Social Security system in 1935 was provided by the extremely high unemployment rates and the failure of financial institutions during the Great Depression, which impoverished a large segment of

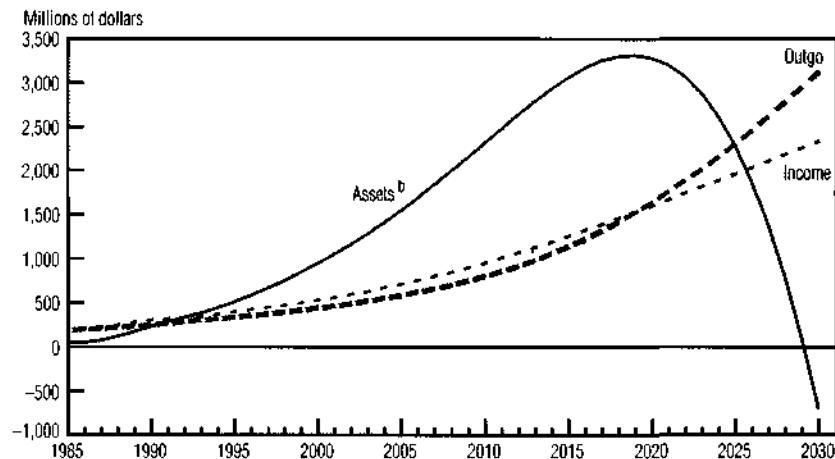
the nation's elderly. The system mandated contributions via payroll taxes during one's working years in exchange for an implicit promise of retirement benefits. At its inception, the payroll tax was set at 1 percent of earnings up to \$3,000 from both employers and employees in all private-sector commercial and industrial jobs.

The initial setup was designed to accumulate a trust fund that paid benefits only to contributors, but it was amended in 1939 to include those elderly who had not contributed during their working years. This amounted to a switch from a funded to a pay-as-you-go system and implied that benefits paid to the initial generations of elderly Americans would have to be covered by future generations. In addition, the 1939 legislation broke the link between individual contributions and benefits by introducing dependent benefits.<sup>3</sup>

The pay-as-you-go system was in effect until 1983, with current revenues being immediately transferred to older generations in the form of retirement (as well as other) benefits. After 1972, benefits grew rapidly because of their overindexation to inflation, and long-range projections of revenue shortfalls worsened — primarily as a result of lower post-1960s fertility rates that translated into fewer working-age individuals per retiree early in the twenty-first century. Hence, in 1977, a new indexation method designed to maintain a constant structure of replacement ratios — the ratios of real benefits to real past earnings — was introduced.<sup>4</sup>

Unfortunately, this new approach proved inadequate to rein in the revenue shortfall, because real benefits were tied to real average wages rather than to the real tax base: A smaller future labor force implied a smaller projected tax base despite rising real average wages. To accommodate higher benefit levels, the 1977 legislation also instituted a gradual increase in tax rates from 12.1 percent to 15.3 percent by 1990. The law further allowed for a gradual rise in the maximum taxable income level. Thus, rather than reduce benefit levels, lawmakers preferred to increase payroll taxes.

**FIGURE 1 SOCIAL SECURITY INCOME, OUTGO, AND ASSETS: 1985–2030<sup>a</sup>**



a. Calendar-year data. Data for 1995 and beyond are projections.

b. End-of-year data.

SOURCE: Board of Trustees of the Social Security Administration, *Annual Report*, April 1995.

By contrast, the Social Security amendments passed in 1983 did cut benefits, but the reductions were postponed until the year 2000. The amendments also boosted payroll tax rates and imposed a greater reduction in benefits for early retirees (those who leave their jobs at age 62). In addition, a gradual increase was imposed in the retirement age at which individuals can qualify for full benefits, and a quarter of Social Security payouts became subject to income taxation.<sup>5</sup> Recently, the Omnibus Budget Reconciliation Act of 1993 increased the taxable fraction to 85 percent.

### ■ Is the Future of Social Security Secure?

The 1983 amendments extended the ability of the Social Security system to meet its obligations for several decades. Current projections indicate that the system will not run out of money until about the year 2030 (see figure 1). Indeed, the 1983 legislation partially restored the funded nature of Social Security. The payroll tax hikes, coupled with the entry of the baby boomers into the work force, are currently generating a surplus of \$63 billion per year — funds that are earmarked for paying benefits to future retirees.

This seemingly secure system may not, however, translate into a secure future for those Americans who are due to retire in the first two decades of the next century. The fact that the Social Security

Administration's books show adequate funding for 30 years does not necessarily mean that the money required to pay benefits to retiring baby boomers will actually be available. Individuals who will turn 65 in the year 2010 may rationally expect to receive their Social Security checks each month. The crucial question, however, is what the rest of the federal budget will look like, and how it will affect the retirement resources of future retirees. Will most Social Security benefits be subject to direct taxation? Would high inflation in the interim erode the real value of future benefits? Would the government, if strapped for funds, cut back on other spending to finance Social Security payouts? Or might sales and other consumption taxes be raised so high that retirees, in attempting to spend the money, will end up handing a major share back to the government?

The ability of Congress to fund retirement benefits in the coming years depends, of course, on whether lawmakers invest current surpluses in income-generating assets — income that could be used to pay future benefits. If the government spends its revenues on current consumption, providing benefits to future retirees will be difficult. The law now requires the Social Security trust fund to invest its surplus in Treasury securities. In reality, what this means is that the funds are available to the government for current spending.<sup>6</sup>

What fraction of government spending is devoted to investment? There is no clear answer to this question. At one extreme, all government nontransfer spending could be thought of as investment, since government operations provide the economy with a framework of laws and institutions and ensure national security, allowing private enterprise to operate smoothly and to prosper. At the other extreme, most government nontransfer spending could be viewed as current consumption, since it does not result in the creation of income-generating assets for the government.

A third perspective is that government spending on items like education, childhood nutrition, and so on, improves the earning power of future generations. That additional income can then serve as a base for higher payroll taxes and help to finance the retirement benefits of current retirees. The efficacy of this channel is questionable, however, because higher (anticipated) payroll taxes might dampen future generations' work incentives. Hence, when the Treasury securities of the Social Security trust fund need to be redeemed to provide benefits to a swelling number of retirees, the absence of corresponding income-generating assets and limits on payroll taxes may mean that future benefits will have to be taxed or scaled back directly.<sup>7</sup>

The taxation of Social Security benefits is already a reality. Today, however, these benefits are subject only to an income tax; thus, only retirees with high asset incomes are affected — that is, the rich elderly. Future taxation of Social Security benefits may assume the form of higher normal retirement ages or taxes on consumption, both of which would affect all recipients. Of course, benefit levels may be reduced directly. That seems less likely, however, given that the relatively large number of future retirees will represent a potent political pressure group.

## ■ Should We Privatize Social Security?

Proposals for privatization assume various forms, and their likelihood for success should be judged by whether they reduce or eliminate the major shortcomings of the current system without introducing new problems. Privatization should not, of course, abrogate the accrued benefits of retired generations or of those about to retire.

Proposals for privatizing Social Security generally recommend publicly mandated, employer-provided pension plans for younger workers, say, those age 50 or less (such plans already exist in the private sector). These workers and their employers would be required to contribute to 401(k)-type pension plans instead of toward Social Security payroll taxes, with the resulting revenue shortfall met through general government revenues. Such a plan, however, would also entail a reduction of future implicit obligations to pay benefits to today's young workers and, as such, would break even in present-value terms.

Under such a scheme, employees would directly control the investment of their contributions in stocks, bonds, or government securities, thereby reducing the risk that the funds will be spent by the government. Separate accounts for employees and their spouses could be established to tighten the link between contributions and benefits, improving work incentives. Such an approach would also gradually eliminate the redistribution of resources from younger and future generations toward older generations with larger consumption propensities. This would increase national saving and ultimately boost investment and economic growth.<sup>8</sup>

Critics point out that under privatization, funds meant for financing retirement would be invested in portfolios that include stocks and hence would be at greater risk than is currently the case. However, this criticism loses much of its force when one considers that investing for retirement involves time horizons of 25 to 30 years or longer. The choice between stocks and bonds (government or corporate) is usually posed as one

between risk and return, with stocks being the high-risk/high-return investment and bonds being the low-risk/low-return investment. Over long periods, however, it may be that the worst return earned on stocks will still exceed the best return on bonds. If so, the risk-versus-return characterization of the trade-off would be irrelevant. Indeed, researchers have demonstrated this to be true during the 1926–1989 period for investment horizons of more than 25 years.<sup>9</sup>

A second criticism is that the intergenerational risk-sharing that is possible under public funding, as well as the goal of redistributing monies from the rich to the poor, may not be feasible under a privatized scheme. However, privatization does not preclude transfers out of the government's general budget to generations that suffer unfortunate economic circumstances or to poor households from rich ones. Indeed, the systematic intergenerational resource transfers entailed in a public pay-as-you-go system and the exposure of funds to government consumption under public funding are probably far more detrimental to saving and long-term economic growth.

## ■ Conclusion

Notwithstanding the seemingly secure future of Social Security for the next three decades, financing future benefits for a growing proportion of elderly Americans will pose a serious economic challenge. Although there are good reasons for public intervention in retirement funding, the current financing and spending rules of the U.S. Social Security system contain several features that reduce work incentives, expose funds to government consumption, and redistribute resources from low- to high-spending generations.

The idea of rectifying some of these defects through mandated contributions to privatized pension schemes, with a tighter link between benefits and contributions, is gaining ground in many countries. It is time for U.S. lawmakers to take a serious look at this option.

## ■ Footnotes

1. The oldest baby-boom generations are expected to begin retiring in the year 2010.

2. The replacement rate refers to the ratio of Social Security retirement benefits to pre-retirement income.

3. Even today, the existence of dependent benefits breaks the link between contributions and benefits, which is a work disincentive for married women.

4. This method is the Average Monthly Indexed Earnings (AIME) approach to computing the Primary Insurance Amount (PIA) for each covered retiree. The computation uses a wage index to inflate past covered earnings and applies a regressive formula to calculate the PIA, which is the monthly retirement benefit.

5. The normal retirement age is scheduled to increase from 65 to 67 over a span of 15 years beginning in the year 2000.

6. Indeed, the stipulation that the trust fund surplus must be invested in government securities may be causing additional government spending by making the resources available to the government at low cost. It is possible, of

course, that investing the surplus in private capital markets would release an equal amount of private capital for buying government debt, leaving the government's ability to finance its spending unaffected. However, if private lenders are unwilling to hold the entire additional amount of public debt at the rates of return being paid to the Social Security trust fund, the cost to the government of financing the added debt would rise, making it more difficult to sustain the current level of public consumption expenditures.

7. Under current projections, trust fund assets will have to be drawn down beginning in the year 2020 (see figure 1).

8. The redistribution of resources from younger to older generations is a consequence of two elements: the pay-as-you-go nature of Social Security and the growth in per capita benefits to each successive generation of retirees. Gradually eliminating the pay-as-you-go setup would prevent growth in the system from automatically causing an intergenerational redistribution of resources. If, under privatization, each generation's benefits were financed by its own prior savings, benefit levels could rise only if those prior contributions were increased.

9. See Thomas E. MacCurdy and John B. Shoven, "Stocks, Bonds, and Pension Wealth," in David Wise, ed., *Topics in the Economics of Aging*, Washington, D.C.: National Bureau of Economic Research, 1992. Data for years prior to 1926 do indicate periods in which bonds outperformed stocks. Nonetheless, the overwhelming weight of the evidence shows that stocks are a better investment over long horizons. Of course, the future behavior of capital markets may not be consistent with past trends.

Jagadeesh Gokhale is an economic advisor at the Federal Reserve Bank of Cleveland. The author thanks Seung An for providing detailed data on Social Security projections.

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Federal Reserve Bank of Cleveland  
Research Department  
P.O. Box 6387  
Cleveland, OH 44101

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