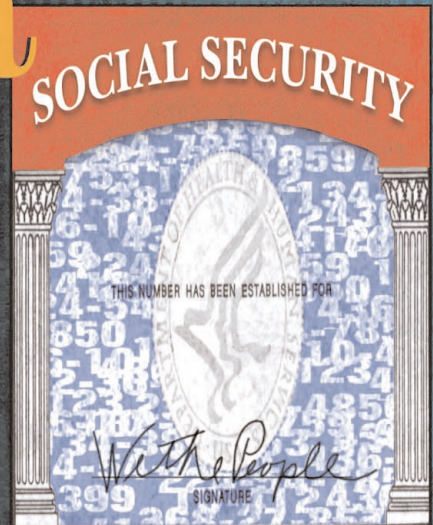


Revised  
**2005**  
Edition

**THE  
BASICS**



# SOCIAL SECURITY REFORM



**A CENTURY FOUNDATION  
GUIDE TO THE ISSUES**



**THE  
BASICS**

**SOCIAL  
SECURITY  
REFORM**  
REVISED  
2005 EDITION

**A CENTURY FOUNDATION  
GUIDE TO THE ISSUES**

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# CONTENTS

INTRODUCTION	4
I. SOCIAL SECURITY IN A NUTSHELL	6
II. WHAT'S RIGHT WITH SOCIAL SECURITY?	10
III. WHAT'S WRONG WITH SOCIAL SECURITY?	17
IV. HOW OUR SYSTEM COMPARES WITH THOSE OF OTHER COUNTRIES	26
V. WHAT'S WRONG WITH PRIVATIZATION?	35
VI. CONCLUSION	46
NOTES	47

## INTRODUCTION

President George W. Bush repeatedly has emphasized that one of his foremost second-term priorities is a fundamental transformation of the Social Security program into a system that includes personal investment accounts. Enacted in 1935 and amended many times since, most recently in 1983, Social Security provides benefits to workers and their family members upon retirement, disability, or death. Since the program's inception, the size of those benefits always has depended on the earnings of workers over the course of their careers. President Bush wants to change the system so that in the future the amount that each worker collects from Social Security upon retirement would depend on the performance of investments in his or her own personal account.

Much is at stake in this debate. More than 96 percent of workers pay Social Security taxes and are thereby entitled to collect benefits from the program. More than 47 million Americans today receive checks from the Social Security system. Although the average monthly payment to those individuals is a modest \$895, Social Security constitutes more than half of the incomes of almost two-thirds of retired Americans. For one in six, it is their only income.

Transforming the system to create new personal accounts for younger workers while continuing to provide payments owed to today's beneficiaries requires a huge infusion of additional money. Although the president had not proposed a detailed plan as of the date this pamphlet was written, most analysts expected the creation of private accounts to require new federal borrowing amounting to trillions of dollars. That additional debt could constrain significantly the nation's overall economic performance and the scope of federal activities years into the future.

President Bush and others who support his approach argue that such dramatic changes are necessary because Social Security faces a financing shortfall. According to the Social Security Trustees' latest estimates, based on intermediate economic and demographic assumptions they deem to be neither optimistic nor pessimistic, Social Security will continue to be able to pay benefits in full until its Trust Funds are exhausted in the year 2042. After that, funding would be sufficient to provide about 73 percent of currently promised benefits. For perspective, it is worth noting that in 1997, the Trustees predicted that the Trust Funds would run out in 2029. So without any changes to the program, the nation's improved economic performance added thirteen years to the estimate of when the system would face a genuine crisis.

The reason why Social Security faces a long-term financing challenge, as most people know, is that the huge baby-boom generation born between 1946 and 1964 will be eligible to begin retiring in about 2008. They will place a strain on Social Security because a smaller share of the U.S. population will be working

and contributing taxes to the system relative to the number who will be collecting benefits.

The retirement of the baby boomers was already on the radar in 1981 when President Ronald Reagan created a commission headed by Alan Greenspan, now chairman of the Federal Reserve, to strengthen Social Security. At that time, the Social Security Trust Funds were nearly depleted, and the Greenspan Commission recommended that those funds be substantially bolstered to avert another such crisis as the boomer generation retired. Those reforms, enacted in 1983, are projected to keep the Social Security program solvent through 2042. Right now, Social Security has reserves in excess of \$1.5 trillion, and those reserves are projected to rise to more than \$6 trillion over the next twenty-five years to absorb the impact of the baby boomers' retirement. It should be noted that by 2042, the majority of the baby-boom generation will no longer be alive.

Whether one favors or opposes the creation of private accounts, the plain fact is that they would make the challenges facing Social Security more immediate and severe. The problem is that financing the accounts while sustaining payments to today's beneficiaries requires drawing down the Trust Funds' reserves much more rapidly, resulting in their depletion about twenty years sooner than they otherwise would be.

It is no exaggeration to say that Social Security has never been more likely to be subject to fundamental restructuring than it is today. That is why, aside from matters of war, the debate over the program's future is more important to the country and its citizens than any other issue before Congress. In the end, the right decision will depend on an informed public. This pamphlet, the fifth updated edition, presents the best available facts, figures, and arguments about what is right with Social Security, what is wrong with it, and the strengths and weaknesses of proposals to convert it into a system reliant on private investment accounts.

## I. SOCIAL SECURITY IN A NUTSHELL

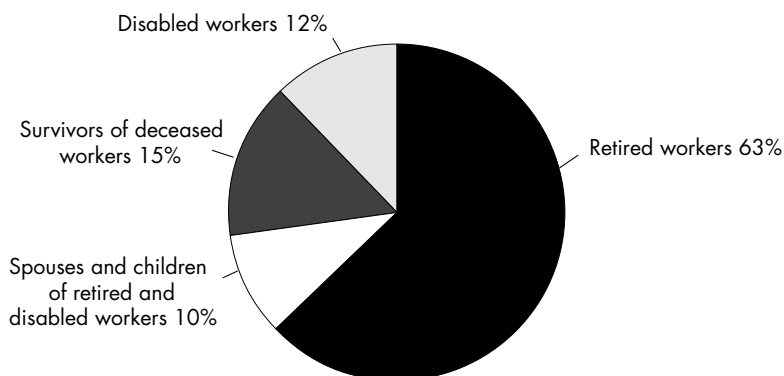


### WHAT IS SOCIAL SECURITY?

► Social Security is a contributory social insurance program providing benefits to millions of Americans. Workers contribute financially to the system during their careers and earn entitlement to family benefits upon retirement, disability, or death. In 2002, more than 47 million Americans received benefits under the Old-Age and Survivors Insurance and Disability

Insurance (OASDI) programs that make up Social Security. This group included some 32 million elderly retirees and their dependents, more than 7 million disabled workers and their dependents, and nearly 7 million survivors of deceased workers. (See Figure A.) Almost 4 million of those receiving OASDI benefits are children.<sup>1</sup>

**FIGURE A**  
**Percent of Beneficiaries in Current-Payment Status, by Type, 2002**



Source: *Annual Statistical Supplement to the Social Security Bulletin, 2003* (Washington, D.C.: Social Security Administration, July 2004), Table 5.A1.



## HOW IS THE PROGRAM FINANCED?

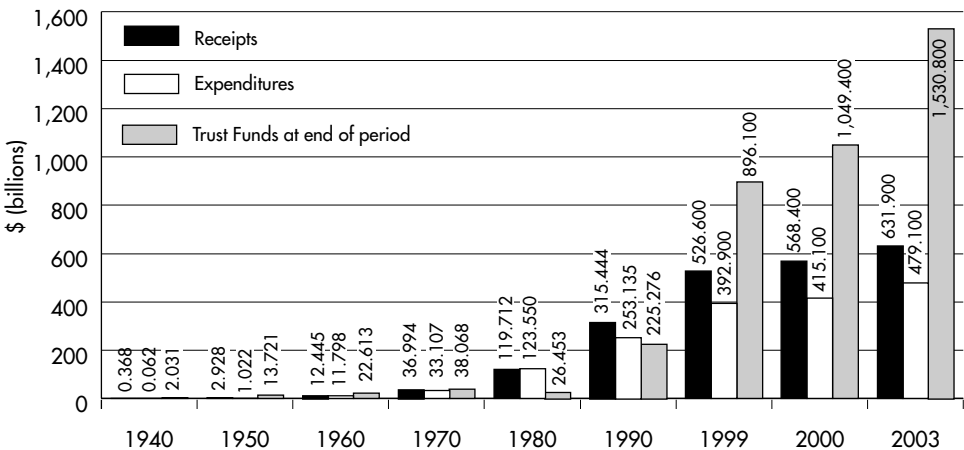
- ▶ About 96 percent of workers in the United States contribute to Social Security,<sup>2</sup> paying a flat tax of 6.2 percent of their wage income up to \$90,000 in 2005; their employers contribute an equal amount.<sup>3</sup> If, however, as many economists believe, employers shift the cost of Social Security taxes onto workers in the form of lower wages, workers in effect may actually bear a substantially larger share of the tax burden than employers.<sup>4</sup> Self-employed people pay both their own and their “employer’s” share; their tax rate is 12.4 percent, half of which is tax deductible for income tax purposes.<sup>5</sup>
- ▶ While the payroll tax is by far the largest source of funding for Social Security, a small amount of additional revenue is raised through the taxation of the Social Security benefits of high-income beneficiaries. For single taxpayers, beneficiaries whose combined income (that is, adjusted gross income plus nontaxable interest plus one-half of their Social Security benefits) is between \$25,000 and \$34,000 may have to pay taxes on 50 percent of their Social Security benefits. Married couples filing jointly that have a combined income between \$32,000 and \$44,000 also may have to pay taxes on 50 percent of their Social Security benefits. Up to 85 percent of the Social Security benefits of those individuals whose combined income is more than \$34,000 and married couples filing jointly whose combined income is more than \$44,000 may be subject to taxation.<sup>6</sup> These tax revenues are channeled into both the Social Security and Medicare programs.
- ▶ Social Security is largely funded on a pay-as-you-go basis. Social Security is not a “piggy bank” that employees put money into and then take out of when they retire. The benefits that today’s Social Security retirees receive are paid out of taxes collected from today’s workers that are earmarked for the payment of these benefits. Out of this tax money, the government writes Social Security checks. Any money left over after paying benefits is put into the Trust Funds, which are invested in U.S. government securities to provide funds for future use. (See Figure B, page 8.)



## WHO IS ELIGIBLE?

- Eligibility for benefits is earned through workers' payroll tax contributions. As noted, nearly all workers in the United States are required to contribute to the Social Security program. All citizens and those with legal alien status who work and pay contributions for the required number of quarters (forty, that is, ten years) are eligible for pension benefits when they reach the minimum retirement age;<sup>7</sup> survivor and disability benefits also require certain minimum work credits. To qualify as disabled, individuals must have a prolonged or terminal condition and may not earn more than \$810 per month.<sup>8</sup>
- Under certain circumstances, a worker's spouse, children, and parents may qualify for Social Security benefits based on the worker's contribution history. Unmarried children under age eighteen (or over eighteen if severely disabled), elderly spouses, and spouses caring for young children are generally eligible for benefits if a worker retires, becomes disabled, or dies. The elderly parents of a deceased worker may be entitled to survivorship benefits if they were financially dependent on the child for at least half their support.<sup>9</sup>

**FIGURE B**  
**Social Security Receipts, Expenditures, and Trust Funds**  
**at End of Period, 1940–2003**



Note: Receipts include net contributions, income from taxation of benefits, reimbursements from the general fund of the Treasury, and net interest. Expenditures include benefit payments, administrative expenses, and transfers to Railroad Retirement program. These figures are for the Old-Age and Survivors Insurance (OASI) and Disability Insurance programs combined, except for 1940 and 1950, which are for OASI only.

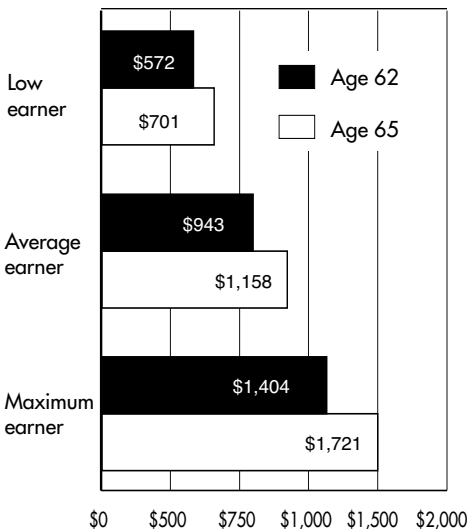
Source: 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds (Washington, D.C.: GPO, 2004), pp. 129, 133. Hereafter cited as 2004 Annual Report of the Social Security Trustees.



## HOW ARE BENEFIT LEVELS DETERMINED?

- ▶ Retirement benefits are based on average earnings during a thirty-five year career. Higher lifetime earnings result in higher benefits up to an inflation-adjusted cap. The full benefit currently is payable at age sixty-five and a half (scheduled to rise gradually to sixty-seven in 2022); workers who retire at age sixty-two get a reduced benefit based on the likelihood of their collecting benefits over a longer term. (See Figure C.) Workers who postpone retirement beyond age sixty-five and a half, up to age seventy, get more than the full benefit. Survivorship and disability benefits are also determined by a worker's average earnings.
- ▶ Some recipients of retirement and survivorship benefits who continue to work will have their benefits reduced if they earn above a certain threshold. In 2005, beneficiaries under age sixty-five and a half will lose one dollar of benefits for every two dollars of earnings above \$12,000. The benefits of individuals aged sixty-five and a half and older are not subject to any earnings test.<sup>10</sup>

**FIGURE C**  
**Hypothetical Benefit Amounts for a Person Who Claimed Benefits in January 2003**



Source: "Fast Facts and Figures about Social Security, 2000," Social Security Administration, June 2003, p. 16. Hereafter cited as "Fast Facts."

- ▶ All benefits are adjusted annually to keep pace with inflation, as measured by the Consumer Price Index (CPI). This means that during periods of high inflation, such as the 1970s, inflation-adjusted benefits protect Social Security recipients from having the real benefits of their Social Security check eaten away by a higher cost of living.<sup>11</sup> Most private pensions do not make similar adjustments for inflation.

## II. WHAT'S RIGHT WITH SOCIAL SECURITY?

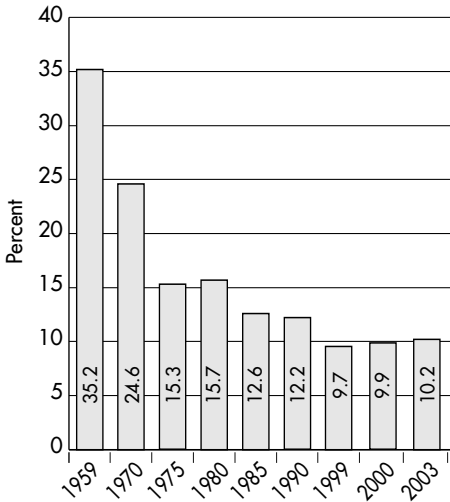
### SOCIAL SECURITY COVERAGE IS NEARLY UNIVERSAL

- About 91 percent of individuals age sixty-five and over receive Social Security benefits; those who continue to work and have not yet claimed benefits are eligible to receive benefits upon retirement.<sup>12</sup> In 2003, around 154 million workers (about 96 percent of individuals in paid employment) were making payroll tax contributions to the Social Security system and building credits toward future benefits.<sup>13</sup>
- Social Security provides a substantial number of workers and their families with *insurance* against the financial risks associated with the death or disability of a breadwinner. Around 90 percent of workers aged twenty-one to sixty-four are eligible for benefits should they become disabled.<sup>14</sup> Nearly all children under age eighteen (97 percent) are eligible for benefits if a working parent dies.<sup>15</sup>

### SOCIAL SECURITY BENEFITS SAVE MANY RETIREES FROM POVERTY

- In 2003, the benefits paid by Social Security exceeded \$470 billion.<sup>16</sup> These benefits, in combination with Medicare health insurance, have dramatically reduced poverty for the aged in America. In 1959, the U.S. Census Bureau estimated that more than 35 percent of elderly Americans were poor.<sup>17</sup> During the 1960s, elderly Americans experienced twice the poverty rate of all other Americans. By 2003, in large part because of changes in the Social Security and Medicare systems, the poverty rate among senior citizens was 10.2 percent. (See Figure D.) This is slightly lower than the rate for other adults.<sup>18</sup>
- Providing workers with pensions is not compulsory for employers in the United States. In 2001, fewer than 44 percent of all workers were enrolled in private pension plans.<sup>19</sup> (See Figure E.)
- Social Security provided 65 percent of the elderly in America with benefits that represented at least half their total income.<sup>20</sup> Without Social Security, approximately 40 percent of the elderly in America would have fallen below the poverty line in 1999.<sup>21</sup> (See Figure F.) A significant portion of the elderly need Social Security to survive: in 2003, 34 percent of elderly recipients relied on

**FIGURE D**  
Poverty Rate Among  
Elderly Americans



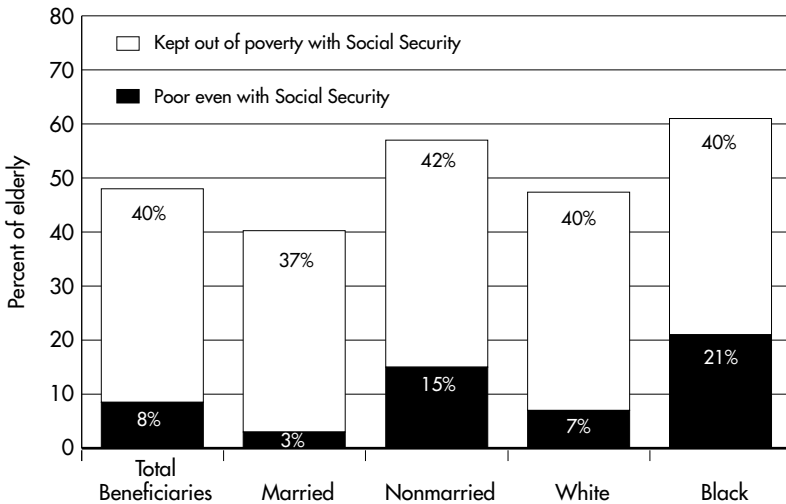
Source: U.S. Department of Commerce, Bureau of the Census, "Income, Poverty and Health Insurance Coverage in the United States: 2003," *Current Population Reports*, August 2004, Table B-2, p. 46.

**FIGURE E**  
Workers Likely to Lack  
Pension Coverage

- ◆ Workers in part-time jobs
- ◆ Workers in small firms
- ◆ Workers who are not members of labor unions
- ◆ Workers in low-paying jobs
- ◆ Workers who are women or members of a minority group

Source: James H. Schulz, *The Economics of Aging*, 6th ed. (Westport, Conn.: Auburn House, 1995), p. 230.

**FIGURE F**  
Elderly and Poverty Status, 1999



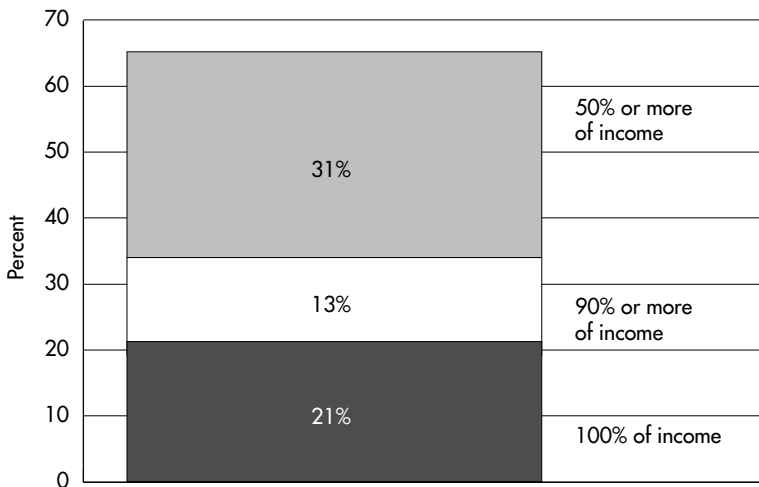
Source: "Fast Facts," p. 8.

Social Security for at least 90 percent of their total income; for 21 percent of recipients, Social Security was their only source of income.<sup>22</sup> (See Figure G.)

➤ Although women retirees usually receive smaller monthly checks from Social Security than do men, they typically have a greater need for Social Security.<sup>23</sup> Of unmarried women age sixty-five and older, for example, 42 percent rely on their Social Security check for at least 90 percent of their income.<sup>24</sup> Women tend to be more reliant on their Social Security checks for numerous reasons:

- ◆ Women tend to earn less than men for work outside of the home. Women are more likely to have interrupted work histories, and the monetary value of women’s work in raising children is not directly calculated in benefits. Thus, women often end up with lower retirement benefits than their male counterparts. The average monthly benefit for a retired woman in 2002 was \$740, compared to \$983 for a man.<sup>25</sup>
- ◆ Only 18 percent of elderly women receive a private pension, compared with 31 percent

**FIGURE G**  
**Beneficiaries with Social Security Benefits**  
**as a Major Source of Income, 2003**



Source: *Social Security: Performance and Accountability Report for Fiscal Year 2004* (Baltimore: Social Security Administration, 2004), p. 9.

of older men. In 2000, the median private pension or annuity income for women sixty-five or older was about \$4,164 annually, compared to \$7,768 for men.<sup>26</sup>

- ◆ More women than men outlive their spouses because women tend to marry older men and to have longer life expectancies. Most women are widowed and live alone after age seventy-

five, while most men are married and live with their wives.<sup>27</sup> Indeed, almost 70 percent of those over age eighty-five are women.<sup>28</sup>

- ◆ Elderly women living alone are more likely to be poor than their male counterparts. Of the almost 2 million elderly poor living alone in 2003, more than 1.6 million were women.<sup>29</sup>



***SOCIAL SECURITY PROVIDES BENEFITS THAT WOULD BE DIFFICULT FOR WORKERS TO MATCH THROUGH PRIVATE POLICIES***

- In 2002, almost 7 million survivors of deceased workers (including almost 1.3 million children) received Social Security benefits. About 6.5 million workers (and their spouses and children) received monthly cash benefits as a result of severe and prolonged disability. Similar retirement and disability insurance policies in the marketplace would be very expensive. For an average wage earner with a spouse and two children, in 2001 the disability policy provided by Social Security was equivalent to a \$353,000 policy in the private sector; Social Security's survivorship insurance was equivalent to a \$403,000 life insurance policy.<sup>30</sup>
- Social Security retirement benefits are portable, following workers from job to job. In contrast, many employer-provided pension plans offer benefits only to workers who stay with the same company for an extended period of time. Social Security benefits are adjusted annually to protect against erosion caused by inflation, whereas private pension programs and insurance plans rarely guarantee such protection. Under Social Security, disability and life insurance coverage is provided without regard to the health of the individual.



## **SOCIAL SECURITY BENEFITS ARE WORK-RELATED AND PROGRESSIVE**

- ▶ Because Social Security is a social insurance program, it is structured so that someone who has had a lifetime of high wages (and was therefore able to save money for retirement) does not have as much of his or her income replaced upon retiring as do low-wage earners. In other words, while those who earned higher wages get a larger check than those who earned less, the check represents a smaller percentage of their average earnings. In turn, the system pays retirees who earned lower incomes benefits that replace a larger percentage of their wages. Workers with a very low wage are guaranteed a minimum benefit.<sup>31</sup>
- ▶ This progressive feature of Social Security helps give all workers in America a chance at a decent retirement, even if the type of work they did, or personal circumstances, did not enable them to accumulate wealth or become eligible for a private pension plan.
- ▶ The Social Security benefits of an average-wage earner with a spouse retiring at sixty-five in January 2004 were about 62.9 percent of his or her average earnings, while comparable figures for low- and high-wage earners were 84.8 percent and 44.6 percent, respectively.<sup>32</sup> (See Figure H.)

**FIGURE H**  
**Social Security**  
**Wage-Replacement Rates, January 2004**  
**(workers age 65)**



Source: *Social Security: Performance and Accountability Report for Fiscal Year 2004*, p. 9.

- ▶ With this structure, Social Security benefits are progressive, although benefits may be less progressive than they seem because of differing life expectancies among high- and

low-income workers. People with more income tend to live longer and, as a result, collect benefits for a longer period of time.<sup>33</sup>



***SOCIAL SECURITY IS AN EFFICIENT PROGRAM  
WITHOUT LOOPHOLES AND COMPLEX  
ADMINISTRATIVE REQUIREMENTS***

- ▶ The program runs smoothly, regardless of political or economic events. Despite wars, economic recessions, and recent government shutdowns, Social Security checks have always reached recipients in a timely fashion.
- ▶ Program financing and administration are handled entirely through

the federal government. Unlike other entitlements, such as Medicaid and welfare, Social Security does not require state and local governments to participate in program financing or administration.<sup>34</sup> Likewise, there are no interstate benefit differences for retirees with similar work histories.<sup>35</sup>



***THERE IS LITTLE WASTE IN THE SYSTEM***

- ▶ Administrative costs for Social Security are less than 1 percent of benefits. According to the American Council of Life Insurance, administrative costs for private insurance are between 12 and 14 percent of annual benefit amounts. Public opinion

polls conducted by the Roper organization, however, show that the public's "median" guess for the administrative costs of Social Security as a percentage of benefits was more than 50 percent.<sup>36</sup>



## **SOCIAL SECURITY HAS ENJOYED BROAD PUBLIC SUPPORT SINCE ITS CREATION**

- In 1935, Americans were nearly unanimous (89 percent) in their support of government assistance to needy elderly people. During the subsequent six decades, Social Security has routinely received strong support. Recent surveys affirm continued support for Social Security. In fact, many Americans advocate higher benefits and program expansions:<sup>37</sup>
  - ◆ Significant majorities agree that Social Security provides useful benefits. In fact, nearly two-thirds of people surveyed thought that benefits were not sufficient.<sup>38</sup>
  - ◆ Most people would prefer higher taxes to benefit cuts in the Social Security system.<sup>39</sup> Fewer than one in ten respondents feel that the federal government spends too much on Social Security.<sup>40</sup>
  - ◆ More than three-quarters of respondents favor universal participation in the program.<sup>41</sup>

## **WHAT WILL YOUR SOCIAL SECURITY BENEFIT BE WHEN YOU RETIRE?**

To find out, you can call  
the SOCIAL SECURITY ADMINISTRATION  
at 1-800-772-1213  
DEAF SERVICES 1-800-325-0778  
BRAILLE SERVICES 1-410-965-6414

or visit the SOCIAL SECURITY ADMINISTRATION'S Web site:  
<http://www.ssa.gov>

### III. WHAT'S WRONG WITH SOCIAL SECURITY?



#### *WITHOUT CHANGES, THE SOCIAL SECURITY TRUST FUNDS MAY BE DEPLETED IN 2042*

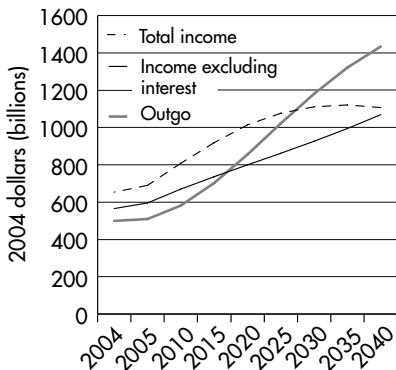
- The Social Security Trustees' projections about the Trust Funds are based on assumptions about demographic and economic trends over the next seventy-five years. Since future conditions are uncertain, the Trustees make three sets of predictions based upon optimistic, intermediate, and pessimistic assumptions. Social Security's finances look dramatically different depending upon which assumptions are used. Under the more optimistic set, the Trustees estimate that Social Security would be adequately funded through 2080; in contrast, the pessimistic assumptions yield a shortfall amounting to 4.96 percent of taxable payroll over the seventy-five-year period. Under the intermediate projection, the shortfall would amount to about 1.89 percent of taxable payroll.<sup>42</sup>
- Because of the upcoming retirement of the baby-boom generation and other demographic trends, the Social Security Board of Trustees projects (under its intermediate set of economic assumptions) that beginning in 2018 annual benefits paid to retirees will exceed payroll tax revenues.<sup>43</sup> (See Figure I, page 18.) Based on those intermediate assumptions, from 2018 through 2027, interest generated from the Trust Funds would be needed to meet current Social Security obligations. From 2028 through 2041, it would be necessary to use principal from the Trust Funds along with accruing tax revenues to meet expenses.<sup>44</sup> By 2042, under those assumptions, the Trust Funds would be fully spent. It is important to note that, contrary to many reports in the media, the system would not become bankrupt or "insolvent" when the Trust Funds run out. Under the intermediate forecast, taxes would be sufficient to pay 73 percent of the obligations to Social Security recipients at that time, declining to about two-thirds by the end of the seventy-five-year period.<sup>45</sup>

- ▶ The Trustees' intermediate seventy-five-year forecast assumes that the U.S. economy will grow at a slower rate than it has in the past. (See Figure J.) It is important to bear in mind that there is no consensus among economists today as to how the economy will perform in the twenty-first century. Few economists predicted that growth would be as high as it was in the late 1990s, while inflation and unemployment remained low. The Trustees' estimate—even the intermediate forecast—errs on the side of caution.
- ▶ Between 1946 and 1964, people who had postponed having children during the Great Depression and World War II began to add to or start families. The oldest members of the baby-boom generation—those born between 1946 and

1964—are scheduled to become eligible for full Social Security benefits in the year 2012.

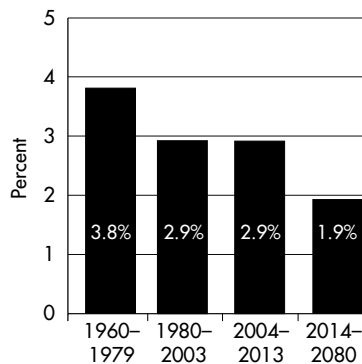
- ▶ At the same time, Americans are living longer. Projections of longer life expectancies and declining birth rates suggest that, after 2030, more than 20 percent of all Americans will be elderly, a larger proportion than ever before. This larger number of retirees will have to be paid their benefits from taxes collected from a smaller pool of workers, relatively speaking. In 2005, there were nearly five people between the ages of twenty and sixty-four for every person aged sixty-five and over.<sup>46</sup> Demographers estimate that in the year 2030, when today's young workers begin to retire, there will be slightly fewer than three persons between the ages of twenty and sixty-four for each

**FIGURE I**  
Estimated OASDI Income and Outgo, 2004–2040



Source: 2004 Annual Report of the Social Security Trustees, p. 178.

**FIGURE J**  
Average of Annual Percentage Changes in Real Gross Domestic Product over Selected Periods



Source: 2004 Annual Report of the Social Security Trustees, p. 94.

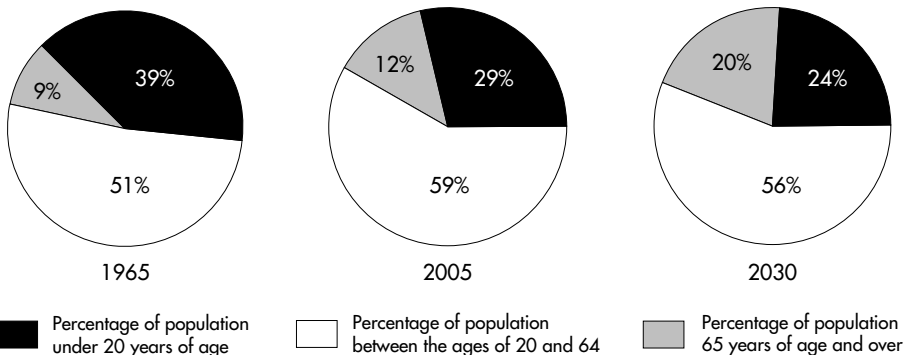
person sixty-five and over.<sup>47</sup> (See Figure K.)

- In technical terms, the problem confronting Social Security is that over the next seventy-five years, based on the anticipated demographic changes just described and assumptions of slower economic growth, Social Security is projected to slip out of balance by an amount equal to about 1.89 percent of total taxable payroll (that portion of payroll subject to Social Security taxes) per year. This means that an immediate increase in the payroll tax of about 1.89 percent (over the current 12.4 percent combined rate) would generate adequate funds to pay full benefits through 2080. Clearly, a payroll tax increase is not the only way to avoid the shortfall, but such an interpretation is useful for gauging the size of the problem.<sup>48</sup>
- The projected deficit has raised fear and concern and has brought

numerous proposals for reform. In assessing any reform proposal, several factors that put the size and scope of the problem into perspective should be considered:

- ◆ Slight modifications in the assumptions underlying the forecasts made by the Trustees show up as large differences in the future financial picture for Social Security. For example, if the Trustees' optimistic assumptions of a slightly higher birth rate, a death rate that falls more slowly than anticipated, and slightly higher immigration than currently expected are realized, there would be no need to change the system. An economic growth rate a little above the rather conservative rate assumed in the Trustees' intermediate forecast also would eliminate the financing problem expected in 2042.<sup>49</sup>

**FIGURE K**  
**Composition of Population, by Age**



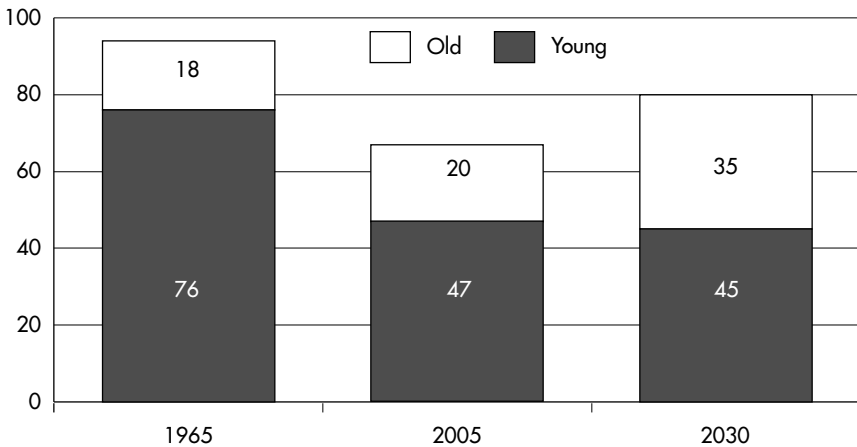
Source: 2004 Annual Report of the Social Security Trustees, p. 78; the 2030 numbers are the intermediate projection.

- ◆ There are a number of demographic shifts that have taken place since the end of World War II that mitigate the financial burden of an increasing elderly population. For example, women entered the workforce in large numbers, and the baby-boom generation produced a baby boomlet. As a result, although there will be more retirees in 2030, the percentage of Americans in the workforce, and thus paying Social Security taxes, is projected to be greater in 2030 than it was during the 1960s at the height of the baby boom.<sup>50</sup>
- ◆ Shifts in the dependency ratio, which measures the number of workers relative to nonworkers

(old and young), can move in either direction: in 1965, the year the baby boom drew to a close, for every 100 Americans of working age there were about 94 dependents, of whom about 18 were age sixty-five and over; in 2005, there were about 67, of whom about 20 were over sixty-five; in 2030, it is projected that there will be about 80, of whom about 35 will be over sixty-five. (See Figure L.)

- The potential problems facing Medicare are considerably more complex, especially when taking into account that the driving force behind expected cost increases is upward pressure on health costs for people of all ages. Even after reforms under the 1997 balanced

**FIGURE L**  
**Number of Dependents (Old and Young)**  
**Supported by 100 Working-Age Individuals**



Source: 2004 Annual Report of the Social Security Trustees, p. 78.

budget agreement, the Medicare Hospital Insurance Trust Fund is projected to be depleted in 2019.<sup>51</sup> Over the next seventy-five years, under certain assumptions, the Trustees of the Federal Hospital Insurance Trust Fund project that the Hospital Insurance Program will have an actuarial deficit amounting to 3.12 percent of covered payroll—a large funding shortfall considering that the program was financed by a 2.9 percent payroll tax in 2004.<sup>52</sup> While the retirement of the baby-boom generation adds to Medicare’s troubles, rapidly rising health care

costs are largely responsible for the funding deficit. Of course, health care inflation is a problem throughout the medical system and not confined to coverage of the elderly. Restoring fiscal soundness to the Medicare program will be a much bigger challenge than fixing Social Security because Medicare’s deficit is much larger and is not simply a by-product of population aging. (For a complete discussion of the financial problems confronting the Medicare program, see our Basics pamphlet, “Medicare Reform.”)



***FUTURE RETIREES WILL PROBABLY RECEIVE LESS  
GENEROUS BENEFITS THAN TODAY’S ELDERLY***

- Most elderly Americans have received Social Security benefits far exceeding what they contributed in payroll taxes during their working years (plus accumulated interest), although the actual benefit-to-contribution ratio depends, of course, on one’s work history and age of retirement. An average-wage employee retiring in 2003 would regain his or her Social Security tax contribution with interest after 7.5 years in retirement. A minimum-wage earner would earn back his or her portion of the tax (with interest) in 8.4 years, while the maximum-wage earner would regain his or her tax contribution in 10.4 years, according to the Congressional Research Service.<sup>53</sup> (Of course, this assumes a continuation of such things as increases that match the rate of inflation.)
- The benefit-to-contribution ratio of Social Security contributions has been declining since the establishment of the Social Security system. Contribution rates were very low when the system was first

designed: the total tax rate was 2 percent in 1937. The earliest retirees paid low taxes for a short period of time (less than their entire career) and received sizable benefits upon retirement, consequently reaping substantial “returns” on their contributions. Over time, as Social Security benefits became more generous and the number of individuals receiving benefits grew, the payroll tax was increased. The benefit-to-contribution ratio of Social Security has declined for each new cohort of retirees because later generations contributed to the Social Security system for the duration of their careers and were subject to higher payroll tax rates.<sup>54</sup>

► The benefit-to-contribution ratio for future generations of retirees is projected to decline further, assuming no changes are made to the system.<sup>55</sup> A single man with low earnings aged sixty-five in 2029 is expected to have an average annual real rate of return from the OASDI program amounting to 2.67 percent, slightly higher than the 2 percent average real return on government bonds. A couple with one worker who earned an average income would receive a substantially higher average real rate of return, 3.97 percent, upon turning sixty-five in 2029. On the other hand, a single male with high earnings would receive a much lower rate of return (1.01 percent).<sup>56</sup>



### ***SOCIAL SECURITY'S PAYROLL TAX IS REGRESSIVE***

► In 2005, Social Security's 6.2 percent payroll tax will be assessed on only the first \$90,000 of a worker's earnings. Because unearned income (interest and capital gains) is not subject to taxation under a payroll

tax and earned income beyond \$90,000 is not taxed, wealthy individuals pay a lower fraction of their total income in Social Security taxes than other people.



## ***SOME FEAR THAT SOCIAL SECURITY DEPRESSES NATIONAL SAVING***

➤ There is great concern that many Americans are not saving adequately for retirement. A low rate of saving in the United States has sparked concern because saving is generally thought to promote economic growth and higher standards of living. There are two related issues: inadequate saving by the nation as a whole—government, firms, and individuals collectively—and inadequate personal saving for retirement by individuals.

◆ **NATIONAL SAVING.** The U.S. national saving rate has been declining for the past thirty-five years. National saving decreased in the 1960s and 1970s because of increasing federal budget deficits (government dissavings). In the 1980s, national saving fell even faster as deficits escalated and, to a lesser extent, private saving declined.<sup>57</sup> Through its buildup of reserves in the Trust Funds, Social Security directly adds to government saving, and thus to national saving.

◆ **PERSONAL SAVING.** At the same time, many Americans may not be saving adequately for retirement. A number of economists have estimated—using a variety of economic assumptions and models—how retirees will fare in retirement. William Gale of the Brookings Institution argues that the extent to which families are prepared for their old age depends on such factors as the living standards they expect, the performance of investment and housing markets, and the growth of the economy generally. Moreover, low- and middle-income families with few assets besides their homes and little or no pension coverage are far more vulnerable than wealthier households that have amassed wealth. In his assessment of married people’s retirement preparation, Gale concludes that “a third of the sample is doing well by any measure, a third is doing poorly by any measure, and the middle third is (or may be) just hanging in there.”<sup>58</sup>

Some suspect that Social Security may be responsible for the low rate of personal saving in the United States. By using tax revenues from workers to provide income for the elderly, some economists have argued, Social Security discourages Americans from saving for their own retirement. Workers may assume that Social Security will provide a sufficient income later and therefore neglect to save now for the future.<sup>59</sup>

But most studies have found little evidence that Social Security has caused a significant decline in personal saving; indeed, economists have had little success in explaining people's saving behavior at all. For example, Federal Reserve Board of Governors' economists could predict only 7 percent of the variation that exists in household saving, and no one has offered a widely accepted explanation for the substantial decline in personal saving in the 1980s.<sup>60</sup>



***SOCIAL SECURITY MAY ENCOURAGE EARLY RETIREMENT,  
PUTTING ADDED PRESSURE ON THE SYSTEM***

- Over the past fifty years, older Americans have been retiring at a progressively younger age. In 1950, 86.9 percent of men aged fifty-five to sixty-four were employed; by 2003, only 68.6 percent of men in this age group were working.<sup>61</sup> Today, most men and women retire before age sixty-five; in fact, almost 56.1 percent receive Social Security benefits at age sixty-two, when reduced benefits for early retirement first become available.<sup>62</sup>
- On the one hand, earlier retirement is a trend that benefits individual workers, allowing them to enjoy a longer retirement than in the past. Most Americans say they would rather retire sooner than later. Furthermore, if individuals continue to retire earlier, this might increase the demand for younger workers. On the other hand, some economists are concerned that earlier retirement, combined with increased longevity, exacerbates the problem of economically sustaining an aging population. If the trend toward early retirement continues as the population ages, an even smaller share of workers will be supporting a larger proportion of retirees.
- Examining the ages at which most Americans retire suggests that the structure of the Social Security program, as well as private pensions, affects retirement decisions.

➤ **THE IMPACT OF THE SOCIAL SECURITY PROGRAM.** The two ages at which most Americans retire are sixty-two, when they first become eligible to receive any Social Security benefits, and sixty-five and a half, when they can receive full Social Security benefits.<sup>63</sup> The program's primary influence on workers' decisions about when to retire are:

- ◆ As currently structured, Social Security benefits for those who retire after the standard retirement age of sixty-five and a half are increased only 6.5 percent for each year retirement is delayed (for individuals who turned sixty-five in 2003–2004), which is not enough to compensate fully for the benefits foregone; the rate will increase gradually, rising to 8 percent for those who turn sixty-six in 2009 and thereafter.<sup>64</sup>
- ◆ People under standard retirement age who continue to work while collecting Social Security face benefit reductions if they earn more than a specified amount.

In recent years, several measures have been adopted that modify the Social Security system so that it provides more incentives for older Americans to continue work:

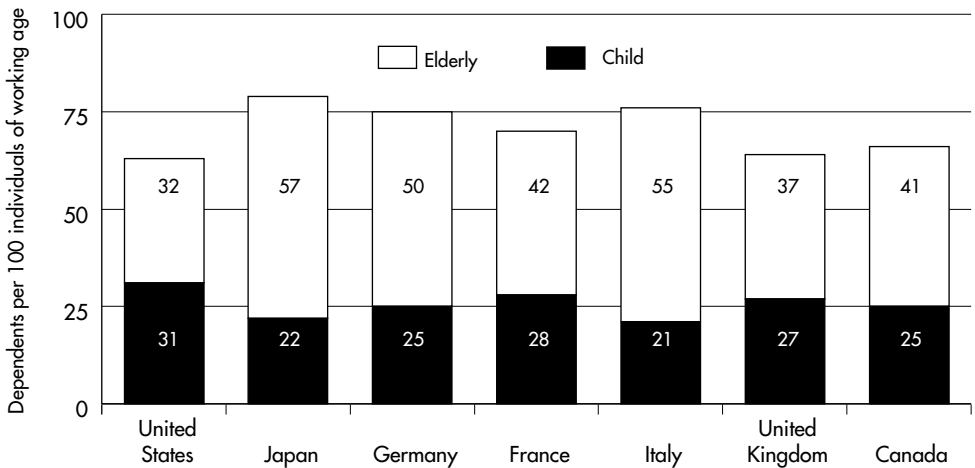
- ◆ Benefits have been increased, and will be increased further, for workers who retire after age sixty-five and a half, adding to the financial incentive to work longer.<sup>65</sup>
- ◆ The retirement earnings test no longer applies to those above the standard retirement age.<sup>66</sup>
- ◆ The standard retirement age is scheduled to rise gradually from sixty-five and a half to sixty-seven by 2022, though individuals will continue to be eligible for reduced-retirement benefits at sixty-two.<sup>67</sup>

➤ **THE IMPACT OF PRIVATE PENSIONS.** Employer-provided defined benefit pension plans appear to have a stronger impact on workers' retirement decisions than Social Security.<sup>68</sup> In most private pension plans, the value of a worker's pension declines substantially if he or she continues to work past normal retirement age.<sup>69</sup>

## IV. HOW OUR SYSTEM COMPARES WITH THOSE OF OTHER COUNTRIES

Because of increasing life expectancy and declining fertility, all of the major industrialized nations will experience substantial population aging over the next thirty years. By 2035, the elderly will make up 20 percent or more of the population in each of the seven big Organization for Economic Cooperation and Development (OECD) nations.<sup>70</sup> Within that group, the United States will have the smallest proportion of elderly individuals. The overall dependency ratios in those countries show similar patterns. (See Figure M.)

**FIGURE M**  
**Projected Total and Elderly Dependency Ratios across the Seven Major Industrialized Countries, 2035**

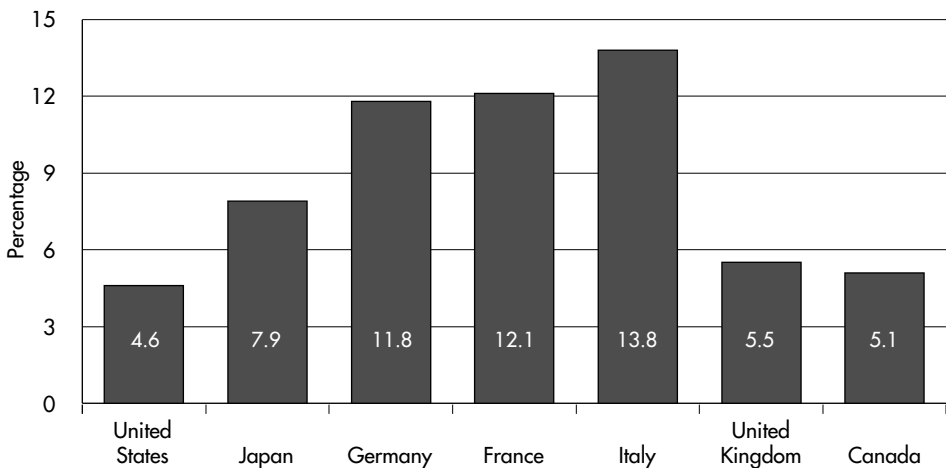


Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, *World Population Prospects: The 2002 Revision and World Urbanization Prospects: The 2001 Revision*, available online at <http://esa.un.org/unpp>.

## SOCIAL SECURITY

- All seven major industrialized nations have social security systems that provide old-age, survivorship, and disability benefits. Each of these systems is funded on a pay-as-you-go basis; the United States, Canada, and Japan accumulate some reserves for future use. Payments to current beneficiaries are financed through payroll taxes on current workers and employers. A few countries, such as Japan and Germany, use general tax revenues in addition to payroll tax collections to finance social security benefits.
- The level of public pension spending varies across the seven major industrialized countries. The United States spends about 4.6 percent of GDP on Social Security. Other countries, including Germany, France, and Italy, spend more than 10 percent of their GDP on public pensions. (See Figure N.) These countries also have roughly proportionate tax rates to finance their public pension programs.<sup>71</sup>

**FIGURE N**  
**Public Pension Spending as a Percentage of GDP, in 2000**



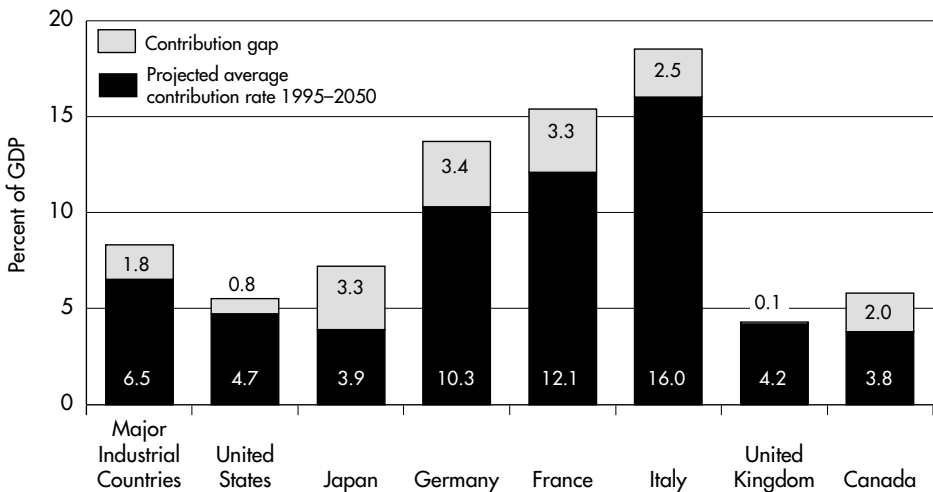
Source: Data from the European Commission and the OECD, cited in Richard Jackson, *The Global Retirement Crisis: The Threat to World Stability and What to Do about It* (Washington, D.C.: Center for Strategic and International Studies, April 2002), p. 18, available online at [http://www.csis.org/gai/global\\_retirement.pdf](http://www.csis.org/gai/global_retirement.pdf).

- ◆ **STRUCTURE OF RETIREMENT BENEFITS.** The structure of retirement benefits varies across nations.<sup>72</sup> All of the seven major industrialized nations pay an earnings-related pension. The United Kingdom and Japan also pay retirees a flat benefit based on the number of years they made payroll tax contributions. Canada supplements its earnings-related pension program with a noncontributory, universal pension.
- ◆ **SOCIAL SECURITY REPLACEMENT RATES.** U.S. Social Security earnings replacement rates (the percentage of one's income at retirement replaced by Social Security) are low compared to the other major industrialized nations. The earnings replacement rate for a retiree with average career earnings is 47 percent in the United States, compared to more than 70 percent in Germany, France, and Italy. While the maximum rate of earnings-related pensions in Canada, the United Kingdom, and Japan are lower than in the United States, these nations supplement their earnings-related pensions with flat benefits that everyone receives regardless of their prior income. In the case of the United Kingdom, however, the base amount is extremely low.<sup>73</sup>
- ◆ **INDEXATION OF BENEFITS.** Like the United States, most industrialized nations index their public pension benefits to protect beneficiaries against inflation. Private pensions typically are not indexed in any country.<sup>74</sup>

## FISCAL CONDITION OF SOCIAL SECURITY SYSTEMS

- The International Monetary Fund projects that, without changes, over the next fifty years, the social security systems in each of the seven major industrialized nations will experience a funding shortfall. The U.S. projected deficit is small compared to that of most of the other nations. Only the British social security system appears to face a shortfall comparable to the one projected for the United States. To restore fiscal balance, the United Kingdom and the United States would need to increase their annual revenues by less than 1 percent of GDP.<sup>75</sup> All of the other nations would require an increase amounting to 2 to 3 percent of GDP.<sup>76</sup> (See Figure O.)

**FIGURE O**  
**Projected Contributions and Shortfalls, as Percent of GDP**

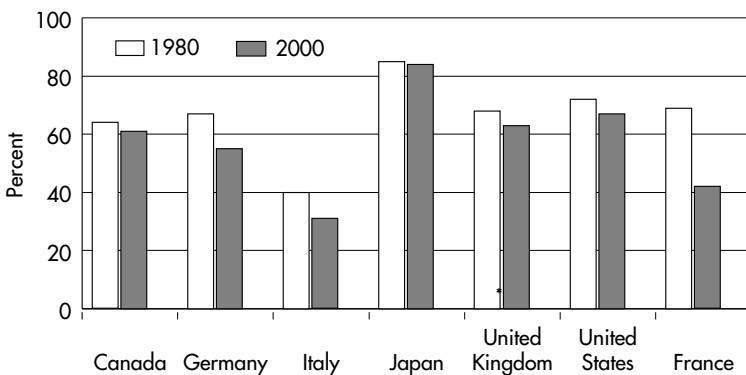


Source: Adapted from Sheetal K. Chand and Albert Jaeger, "Aging Populations and Public Pension Schemes," IMF Occasional Paper no. 147, International Monetary Fund, Washington, D.C., 1996, p. 17.

## COMPARING THE OTHER COMPONENTS OF RETIREMENT SUPPORT

- The adequacy of public pensions and the appropriate measures of reform depend, in part, on other sources of income available for seniors, including the following: earnings from work, pensions, savings, and public health care.
  - ◆ **WORK.** Of the seven major industrialized nations, the United States, Germany, Japan, and Canada set normal retirement age in the sixty-fifth year for both men and women. In the other countries, the retirement age is lower. (In the case of the United Kingdom, men have a retirement age of sixty-five while women can retire at sixty.) The United States stands apart from other countries in that age discrimination and forced retirement are against the law.<sup>77</sup> Most workers outside the United States are retiring at steadily younger ages, on average.<sup>78</sup> (See Figure P.)
  - ◆ **PENSIONS.** In addition to public pension programs, several of the major industrialized nations have large, private pension systems. In general, countries with less generous social security systems have greater accumulations of private pension assets. The United States and United Kingdom have the largest holdings of private pension assets as a percentage of GDP among the G-7 nations.<sup>79</sup> Total pension fund reserves in the United States in 2003 amounted to \$9.2 trillion, slightly less than the nation's GDP of \$11 trillion.<sup>80</sup>

**FIGURE P**  
**Labor Force Participation Rates of Older Males (age 55–64)**  
**1980 and 2000**



*Note:* Figures for the United Kingdom use 1990 data instead of 1980.

*Source:* Bernard Casey et al., "Policies for an Ageing Society: Recent Measures and Areas for Further Reform Economics," Department Working Papers no. 369, Organization for Economic Cooperation and Development, Paris, November 23, 2003, p. 40.

- ◆ **SAVINGS.** Currently, household savings in the G-7 countries range from very low rates in the United States and Canada to more than 10 percent in Germany, Italy, and France. Possible explanations for the variations in saving rates range from cultural differences to tax policies and demographic distinctions.<sup>81</sup>
- ◆ **HEALTH CARE.** All of the G-7 countries have some package of health care for senior citizens. American seniors receive coverage through the Medicare program. (The United States, of course, has a much higher proportion of working-age adults and children without health insurance.) Yet, unlike citizens in other countries, American seniors incur substantial “out-of-pocket” health care expenses: 19 percent of health care expenditures for Medicare beneficiaries are paid for out-of-pocket.<sup>82</sup> It is estimated that health expenditures amount to about 22 percent of family income for seniors.<sup>83</sup>

***TRENDS IN REFORM MEASURES***

- Since the 1980s, industrialized countries in general have become increasingly aware of the impending retirement of the large baby-boom cohort. Several countries, including Germany, Japan, and Italy, have made incremental changes in their systems, restoring fiscal balance through relatively minor alterations in revenues or expenditures. These changes include increasing the retirement age, tightening eligibility requirements for early retirement or disability benefits, and lowering benefits.<sup>84</sup> Means-testing some or all of the public pension benefit has been implemented in Canada and Denmark, for example.
- Advocates of privatization often cite other countries, such as the United Kingdom and Chile, where governments pushed workers into personal investment accounts to reduce the long-term obligations of their social security systems as models for the United States to emulate. But the sobering experiences in those countries actually provide strong arguments against privatization.
- ◆ **UNITED KINGDOM.** The British pension system is now made up of two parts. The first tier, National Insurance, is a minimal, flat benefit supported by lump-sum contributions by workers and employers. In 1978, an earnings-related benefit, the so-called State Earnings Related Pension Scheme (SERPS), was put into place. SERPS also was financed by payroll tax contributions.

Unlike the current U.S. Social Security system, the British system allows SERPS contributions to be taken out of the government's retirement system and placed into approved, private defined benefit schemes. To compensate for "contracting out," workers and their employers pay a lower rate for the National Insurance contribution.

In an effort to cut costs for the program and reduce the government's involvement with social welfare programs, the Thatcher government strengthened financial incentives for workers to "opt out" of the state-supported system for a private plan, which would lessen government obligation to future retirees.<sup>85</sup>

The consequences associated with this policy shift were significant. SERPS benefits were reduced, and the pensionable age for women will be increased. Many Britons found themselves with smaller pensions because of a change in the index for inflation and poor investment decisions with their private accounts (as well as unscrupulous brokers). Lower pensions led to an increase in means-tested income maintenance programs. Finally, the national government was left with new administrative expenses, lost tax revenues, and responsibilities to bail out some failed private pension programs.

Problems were so wide-ranging that even the most enthusiastic supporters of private accounts now say that the United Kingdom simply did not do it right. A government commission headed by Adair Turner reported in October 2004 that Britain had been living in a "fool's paradise" by thinking it had solved its pension problems. According to pension experts at the Organization for Economic Cooperation and Development (OECD), the Turner report has sounded alarm bells. "What looked like a very good idea from a financial perspective in cutting costs has put pensioner poverty, which had been all but eradicated, back on the agenda."

Difficulties with the system prompted a number of new reforms. Beginning in 1999, the Labour government instituted a series of steps that greatly increased the generosity and eligibility pool for the basic income-tested benefit. The SERPS program was abandoned and replaced by the Second State Pension (S2P) in 2002. The new pension, while maintaining SERPS benefit levels for high-income earners, includes explicit redistributive mechanisms: all workers earning below a certain minimum threshold automatically receive 40 percent of that threshold value in their pensions.

- ◆ **CHILE.** Before 1981, Chile had a pension system that was theoretically fully funded, with most of the contributions made by employers. But the system was riddled with problems. Many individuals did not

participate in the program, and rapid inflation was devaluing the accumulated pensions. Moreover, benefits were calculated on the basis of an individual's earnings in only the last few years of work, creating more costly obligations than if his or her entire work history (with lower wages in the early years) were taken into account.<sup>86</sup>

The privatized pension scheme was put into place by a military dictator, Augusto Pinochet, and his assistant, José Piñera. In contrast to the old system, the new, privatized system is financed entirely by employee contributions, with at least 10 percent of workers' salaries going for old-age pensions and 3 to 3.5 percent for survivor and disability pensions. These personal investment accounts are managed by a small number of private companies. In addition, the Chilean government supports a minimum benefit provision (about 85 percent of the legal minimum wage), which is financed through general tax revenues. Unlike the U.S. public pension system, which has a long history, the Chilean model is still very young. Yet the system faces actual and potential problems:

- ▲ **Volatility.** For more than a decade, the returns on personal, private accounts seemed spectacular. The privatization of state enterprises and, from 1985 to 1991, high interest rates contributed to an average annual real return over fifteen years of 16.6 percent, peaking at 35 percent from 1989 to 1991. But subsequently Chile's economy cooled, and so have returns on personal pension accounts. Comparing returns on pension funds to bank deposits during the 1990s, the World Bank found in a 2004 report that "the difference [in returns] shrunk significantly (6.6 percent real yield on deposits, 9.8 percent real return on pension funds), and may not have compensated for their much greater volatility (1.1 against 8.5 percent)."<sup>87</sup>
- ▲ **Inadequate provision.** The same World Bank report cited above expressed disappointment that in Chile, and in most other Latin American countries that followed in its footsteps, "more than half of all workers [are excluded] from even a semblance of a safety net during their old age." The investment accounts of retirees are much smaller than initially anticipated—so low that 41 percent of those eligible to collect pensions continue to work.
- ▲ **High administrative costs.** Voracious commissions and other administrative costs have swallowed up large shares of those accounts. The brokerage firm CB Capitales calculated that when

commission charges are taken into consideration in Chile, the total average return on worker contributions between 1982 and 1999 was 5.1 percent—not 11 percent as calculated by the superintendent of pension funds. That report found that the average worker would have done better simply by placing pension fund contributions in a passbook savings account.<sup>88</sup>

- ▲ **High transition costs.** The transition costs of shifting to a privatized system in Chile averaged 6.1 percent of GDP in the 1980s and 4.8 percent in the 1990s and are expected to average 4.3 percent from 1999 to 2037. Those costs are far higher than originally projected, in part because the government is obligated to provide subsidies for workers failing to accumulate enough money in their accounts to earn a minimum pension.<sup>89</sup>
- ▲ **Outliving pensions.** In the U.S. Social Security program, consistent retirement benefits are guaranteed for the remainder of a worker's life. Under a so-called defined contribution plan, such as Chile's, it is possible for a worker's pension to "run out." The level of benefits received at retirement is not guaranteed to last for the retirees' lifetimes.

## THE STOCK MARKET: A HISTORY LESSON

While the stock market's performance in the late 1990s was, for the most part, impressive, the twenty-year average for stock market performance—the approximate period of an individual's saving for retirement—has been far less predictable.

*Since 1900, the 20-year average real total return on the stock market fell to about zero three times—1901 to 1921, from 1928 to 1948, and from 1962 to 1982. . . . Of course, the returns were substantially negative after paying taxes on interest and dividends. In between were periods in which the 20-year average stock market returns peaked at rates ranging from 6% to 10%. This meant that some people earned a negative real return from investing in the stock market, while others received a real pretax return as high as 10%.*

—JOHN MUELLER

former economic counsel to the  
U.S. House of Representatives' Republican caucus

## V. WHAT'S WRONG WITH PRIVATIZATION?

President Bush has made Social Security transformation one of the central objectives of his second term. The administration wants to change the system so that the amount that each worker collects from Social Security upon retirement would depend on the returns on investments in his or her own personal account, in place of a simple link between earnings history and benefits.

Although the administration has not endorsed a specific plan as of the date this was written, the President's Commission to Strengthen Social Security put forward three proposals in 2001 that likely will form the basis for the plan to create private accounts. An analysis of those proposals showed that paying for new personal accounts while continuing to provide benefits to Social Security's current beneficiaries would require some combination of federal borrowing, tax increases, and benefit cuts amounting to trillions of dollars<sup>90</sup> over the coming decades.

Addressing Social Security's potential long-term financing challenges by taking the dramatic step of diverting its payroll taxes to create new personal accounts would represent a radical departure; it also would be a bad idea. Here are reasons why less costly, less risky, and less painful changes should be considered instead:



### ***UNDER PRIVATIZATION, TODAY'S INSURANCE TO PROTECT WORKERS AND THEIR FAMILIES AGAINST DEATH AND DISABILITY WOULD BE THREATENED***

- "Rate of return" calculations neglect the value of Social Security's insurance protections. Of the 47 million Americans who collect payments from the Social Security program, more than 37 percent (almost 17 million) are not retired workers. Among those currently receiving Social Security payments are 5 million spouses and children of retired and disabled workers, 7 million spouses and dependent children of deceased workers, and 7 million disabled workers and their dependents. Proposals to privatize Social Security involve shifting some of the money financing the current insurance program into investment accounts assigned to each worker. But the payroll taxes carved out to pay for personal accounts are resources that are needed to support today's payments to recipients of Social Security's survivors and disability

insurance as well as retirement benefits. Simple arithmetic suggests that every dollar shifted from Social Security programs to personal accounts is a dollar less to provide guaranteed income to the 37 percent of beneficiaries who are not retired workers.

➤ The three alternatives put forward by the President's Commission to Strengthen Social Security would, in the absence of individual accounts, restore long-term Social Security solvency either largely or entirely through benefit reductions that would apply to all beneficiaries—including the disabled. In the principal proposals put forward by the commission, the reduction in disability benefits was draconian,<sup>91</sup> with cuts ranging from 19 percent to 47.5 percent after the year 2030. The commission itself somewhat disavowed this aspect of its proposals, suggesting that a subsequent commission or other body that specializes in disability policy might revise how its plans apply to the disabled.

➤ Economists have noted that the disabled would have limited ability to use their individual accounts to mitigate the effects of these benefit reductions. One reason is that their individual accounts often would be meager, since those who became disabled before retirement age might have had relatively few years of work during which they could have made contributions to their accounts. Second, under the commission proposals, disabled beneficiaries (like all other beneficiaries) would not be allowed access to their individual accounts until they reached retirement age.

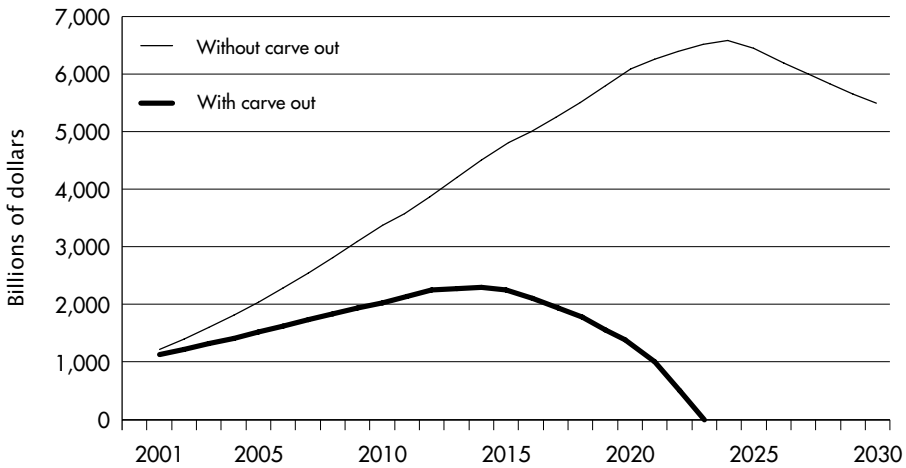
➤ As the Bush commission itself acknowledged, preserving existing disability and survivor's insurance greatly escalates the cost of financing private accounts. It is difficult to imagine how any Social Security privatization plan can avoid significant cuts in those essential protections.



## **CREATING PRIVATE ACCOUNTS WOULD MAKE SOCIAL SECURITY'S FINANCING PROBLEM WORSE, NOT BETTER**

- Social Security is funded by a flat tax of 12.4 percent of each worker's wage income, up to \$90,000 in 2005, split evenly between employers and employees. About four out of five of those tax dollars go immediately to current beneficiaries, and the remaining dollar is used to purchase U.S. Treasury securities held in the system's Trust Funds. Beginning in 2018, well after the huge generation of baby boomers born between 1946 and 1964 begins to retire, a portion of general income tax revenues will be needed to pay interest and eventually principal on those bonds to finance benefits fully. A "crisis" is not forecast to arise until the program becomes entirely "pay as you go" again (as it was throughout its history before 1983) in either 2042 according to the Trustees' forecast or 2052 according to the Congressional Budget Office. (By way of perspective, in 2052 the oldest surviving baby boomers will be 106 years old and the youngest will be 88.)
- Diverting two percentage points of the payroll tax to create private accounts as proposed by the President's Commission to Strengthen Social Security does not sound very radical, but it would shorten significantly the time until sustaining current benefit levels would require raising taxes. In part, this is because money now being set aside to build up the Trust Funds to provide for retiring baby boomers would be used instead to pay for the privatization accounts. The government would have to start borrowing from the private sector almost immediately to be able to meet commitments to retirees and near-retirees. As Figure Q shows (see page 38), the Trust Funds would be exhausted before 2030 instead of the thirty-eight to forty-eight years currently projected. (A diversion of four percentage points of the payroll tax would accelerate the Trust Funds' depletion even faster.) In such a short time frame, the investments in the personal accounts will not be nearly large enough to provide an adequate cushion. As a result, a much larger share of today's workers would confront large benefit cuts, or tax increases, than if no changes were made.

**FIGURE Q**  
**The Effect of a 2 Percent Carve Out on Trust Fund Assets**



Source: Based on analysis in Peter A. Diamond and Peter R. Orszag, "An Assessment of the Proposals of the President's Commission to Strengthen Social Security," The Brookings Institution, Washington, D.C., June 2002.

**CREATING PRIVATE ACCOUNTS COULD DAMPEN ECONOMIC GROWTH, WHICH WOULD FURTHER WEAKEN SOCIAL SECURITY'S FUTURE FINANCES**

- Privatizing Social Security will increase federal deficits and debt significantly while increasing the likelihood that national savings will decline. As a result, long-term economic growth and the size of the economic pie available to pay for the retirement of the baby-boom generation could be reduced.
- ◆ *The 2004 Economic Report of the President*<sup>92</sup> included an analysis of the fiscal impact over time of the most commonly discussed privatization proposal by the president's commission. It found that the federal budget deficit would be more than 1 percent

of gross domestic product (GDP) higher every year for roughly two decades, with the highest increase being 1.6 percent of GDP in 2022. The national debt levels would be increased by an amount equal to 23.6 percent of GDP in 2036. That means that, thirty-two years from now, the debt burden for every man, woman, and child would be \$32,000 higher because of privatization.

One impact of such increases in federal deficits and debts as a result of privatization is that they are likely to raise

interest rates substantially, increasing the cost to the average household of mortgages, car loans, student loans, credit cards, and so on. As a result, the economy would be likely to grow more slowly than otherwise.

- ◆ Economists believe that increased national savings, especially in a country with savings levels as low as they are in the United States, can increase growth by keeping interest rates low and financing investments in productive activities. Although creating private accounts with increased federal borrowing at first blush would seem unlikely to affect national savings because additional savings in the new accounts would offset any new government borrowing to

pay for those accounts, privatization actually is more likely to reduce than increase national savings.

Researchers have pointed out that evaluating the overall effect on national savings requires taking into account the likely responses of government, employers, and households.<sup>93</sup> Historically, neither the government nor employers have changed their spending levels consistently in response to large changes in deficit levels. But households that consider the new personal accounts meaningful increases in their retirement wealth might well reduce their other saving. That, in turn, would further weaken economic growth and our capacity to pay for the retirement of the baby boomers.



### *PRIVATIZATION HAS BEEN A DISAPPOINTMENT ELSEWHERE*

- Privatization advocates characteristically promote the experiences of Chile and the United Kingdom in experimenting with personal investment accounts for workers as models for the United States to emulate. In setting up these mandatory retirement savings schemes with investment options for individuals, Chile and the United Kingdom

hoped to rein in the rising obligations of their social security systems. But, as seen in Section IV of this pamphlet, those countries actually have witnessed an increasing incidence of pensioner poverty, investment returns that have disappointed, and costs of managing the individual accounts that have proved staggeringly high.



## ***THE ODDS ARE AGAINST INDIVIDUALS INVESTING SUCCESSFULLY***

- Privatization advocates like to stress the appeal of “individual choice” and “personal control” while assuming in their forecasts that everyone’s accounts will match the overall performance of the stock market. But studies by a number of economists have demonstrated that individual investors are far more likely to do worse than the market generally, even excluding the cost of commissions and administrative expenses. Indeed, research has found that professional money managers themselves over time significantly underperformed indexes of the entire market.<sup>94</sup>

Moreover, a number of surveys show that most people lack the

knowledge to make even basic decisions about investing. For example, a Securities and Exchange Commission report synthesizing surveys of investors found that only 14 percent knew the difference between a growth stock and an income stock, and just 38 percent understood that when interest rates rise, bond prices go down. Almost half of all investors believed incorrectly that diversification guarantees that their portfolios will not suffer if the market drops, and 40 percent thought that a mutual fund’s operating costs have no impact on the returns they receive.<sup>95</sup>



## ***WHAT YOU GET WILL DEPEND ON WHETHER YOU RETIRE WHEN THE MARKET IS UP OR DOWN***

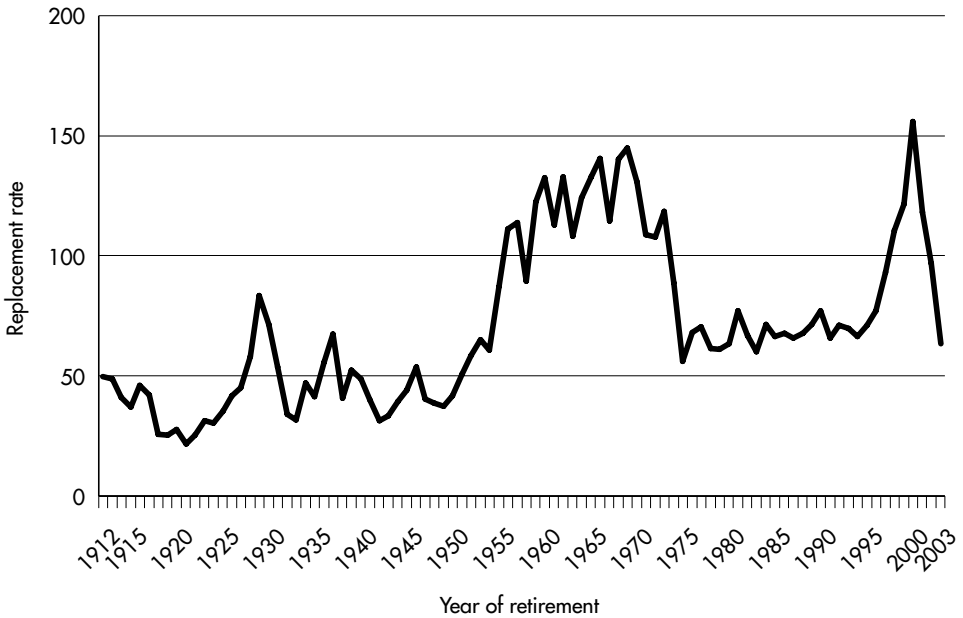
- In the twentieth century, when stocks generally grew significantly, there were three twenty-year periods over which the market either declined or did not rise. The volatility of investment markets means that it matters a great deal whether one retires during an upswing or downturn. For example, a worker who invested his or her retirement

fund in a stock portfolio that matched the Standard & Poor’s 500 index and cashed out upon retirement in March 2000 would have a nest egg almost a third larger than someone who retired just a year later using exactly the same investment strategy because the stock market plunged over those twelve months.

➤ Gary Burtless of the Brookings Institution demonstrated how much timing matters under privatization by examining what would have happened to workers with forty-year careers who retired in each year from 1911 until 2002.<sup>96</sup> Following Burtless’s method, Figure R assumes that each worker put 7 percent of his or her earnings in the

stock market every year (reinvesting dividends) and earned the actual historical return, year by year. It shows the wide variation in the retirement income workers would have received. Clearly, some workers would do much better than others based simply on when they happened to retire—that would be a major change from today’s system.

**FIGURE R**  
**Value of Annuity Purchased at Retirement with Individual Account Invested in Stocks**



*Note:* Assumed contribution rate is 7 percent of wages. Author’s tabulations of U.S. equity and bond return data supplied by Global Financial Data (March 2003). Replacement rate is defined as retirement income expressed as percent of earnings just before retirement.

*Source:* Gary Burtless, personal communication.



## WALL STREET WOULD REAP WINDELLS

- Brokerage houses, banks, and mutual funds have been very active in the campaign to privatize Social Security, since they stand to gain enormous fees if billions of dollars are shifted each year from Social Security payments into accounts under Wall Street management. The problem is that those fees will come from the balances in individual accounts, reducing whatever gains the accounts achieve.
- Among the one hundred best stock mutual funds, management fees range from 0.2 percent to 1.4 percent of the asset value of an account per year. The average is near the high end of that range, however, and many mutual funds charge substantially more. Smaller accounts require proportionately larger management fees because many costs such as gathering and mailing out information do not depend on account size. Indeed, most mutual funds actively discourage small accounts by setting a minimum opening deposit of \$1,000 to \$3,000.
- Experience in the United Kingdom offers a warning about what the future could bring regarding management costs. Workers there were allowed to open private accounts starting in 1988, since which time management fees and marketing costs among financial intermediaries have eaten up an average of 43 percent of the return on investment.



## **PRIVATE ACCOUNTS WOULD REQUIRE A NEW GOVERNMENT BUREAUCRACY**

- From the standpoint of the system as a whole, privatization would add enormous administrative burdens. The government would need to establish and track many small accounts, perhaps as many accounts as there are taxpaying workers—147 million in 1997.
- Many workers' accounts would be so small that they would be of no interest to profit-making firms. The average taxable earnings of a worker are roughly \$25,000 (in 1997, the last year with complete data, the average taxable earnings of the workers who paid into the system were \$22,400). Two percent of \$25,000 comes to \$500 per year.

Francis X. Cavanaugh, who has supervised the thrift savings program for federal employees, a program that privatization advocates often point to as a model, has argued that the costs of administering so many small accounts would overwhelm any benefits to be gained from the stock market.<sup>97</sup> For example, he estimates that the government would need to hire ten thousand highly trained workers just to oversee the accounts and answer questions from workers. In contrast, today's Social Security has administrative costs amounting to less than 1 percent of annual revenues.



## YOUNG PEOPLE WOULD BE WORSE OFF

- Social Security privatization is often sold to young adults as a much better deal for them than the current system. But two recent studies show that if Social Security is converted to a system of private accounts, younger generations will be the ones who bear the costs of transforming the program. The added costs arise from the huge increases in federal borrowing needed to finance the new accounts while continuing to direct payroll taxes toward existing benefits for current retirees. According to the Congressional Budget Office, “to raise the rate of return for future generations by moving to a funded system, some generations must receive rates of return even lower than they would have gotten under the pay-as-you-go system.”<sup>98</sup>
- A July 2004 Congressional Budget Office analysis of a private account proposal by the President’s Commission to Strengthen Social Security compares it with the existing system. It looks at two scenarios for the traditional Social Security system, one with payments continuing in full indefinitely and the other with the Trust Funds becoming depleted in a few decades and payments shrinking to three-fourths their current level. In both scenarios, nearly all birth cohorts at all income levels born from the 1940s through the first decade of the twenty-first century on average do worse under the proposed system of private accounts. Only individuals in the lowest-earning quintiles from the 1950s and the 1990s do slightly better, on average. Even assuming a worst-case scenario, where the Trust Funds evaporate and benefits are cut substantially, cohorts from the 1960s to 2000s would see reductions with private accounts between 1 percent and 17.5 percent on average, depending on their income and birth year.<sup>99</sup>
- An earlier analysis by major economists used the broad outlines of then-Governor Bush’s Social Security privatization proposals to compare retirement benefits under current law to those if private accounts were introduced. They found that benefits for an average-earning worker who retired in 2037 at age sixty-seven (someone aged thirty-four today) would be 20 percent lower than they are now, given historical rates of return in the stock market over a fifty-year period.<sup>100</sup>



## ***RETIREES WILL NOT BE PROTECTED AGAINST INFLATION***

- Social Security privatization plans, including all three recommended by the President's Commission to Strengthen Social Security, require retirees to convert the lump sums in their personal accounts into annuities that provide them with monthly payments until their deaths. The reason for that is that otherwise retirees could outlive their nest eggs or even squander them, requiring taxpayers to bail them out.
- The market for annuities, which are financial contracts sold by insurance companies, is small now, with relatively few bought and sold. Such a market would probably develop under privatization, but it is unlikely that those annuities would include inflation protection, as today's Social Security benefits do. Without inflation protection, the purchasing power of retirees' pensions would fall precipitously during times when prices are rising rapidly. If insurance companies were to offer annuities with inflation protection, they would be likely to charge very substantial fees over and above the already steep 10 percent that they now charge.

## VI. CONCLUSION

Back in 1997, Social Security's Trustees projected that the system's Trust Funds would become depleted in the year 2029. In its most recent report, the Trustees forecast that the Trust Funds would last until 2042. That significant improvement in the system's long-term prospects occurred without a single change to the program. The main reason why Social Security became stronger is that the economy performed better than anticipated, which in turn helps the Trust Funds grow faster while expanding the wealth available for all Americans to share.

The lesson of that experience is, in essence, "do no harm." According to the best forecasts, Social Security can sustain its current protections for decades to come. The system works, and the public is happy with it. Certainly, there is no logical rationale for taking the radical step of diverting payroll taxes into private accounts, thereby making the financing challenge confronting Social Security far more immediate and severe.

If, over time, it becomes increasingly evident that steps need to be taken to prevent a shortfall, then relatively modest reductions in benefits and increases in revenues should be explored to bolster the program. But for now, despite the political rhetoric swirling about, there is no need to mess with a good thing.

## NOTES

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## “WE WERE THERE AT THE BEGINNING”

Edward A. Filene, who founded The Century Foundation (formerly the Twentieth Century Fund) in 1919, believed that “social progress suffers when it is sponsored by well-meaning but untrained minds.” To ensure that those who determine our future, in the halls of our legislatures and in the voting booth, have the information they need when making decisions on social issues, the Fund has long engaged in research and analysis of the needs of all Americans and the resources available to meet those needs.

At the time of the inception of the Social Security program in the mid-1930s, we set up a “Committee on Old-Age Security” to look at the provisions of the Townsend Plan, a movement in this country to provide some pension protection for the elderly in the aftermath of the Great Depression. In examining the plan, the Committee was determined to discover how “the necessities of the aged can best be met without injury to the economic structure on which the entire population depends.” That is exactly the kind of fair-minded analysis we continue to promote.

The Committee determined that “the Townsend plan was dangerously unworkable, [but] its members were deeply impressed with the serious plight of millions of the aged in the United States and with the urgent need for their protection.” As a result it continued its work, and in 1937, under our auspices, *More Security for Old Age*, a report and program for action was published. It provided an analysis of the newly created Social Security program.

Through the ensuing years, we have returned to the issue frequently. In 1956, we published *Economic Needs of Older People* by John J. Corson and John W. McConnell; when the Social Security program faced a crisis in 1983, we published W. Andrew Achenbaum’s *Social Security: Visions and Revisions* as well as some studies of public and private pensions; and recently, we have again returned to this critical issue and are supporting numerous studies and reports and we have established a Social Security Network on the World Wide Web—[www.socsec.org](http://www.socsec.org).

Here, in this revised edition of our pamphlet, *Social Security Reform*, we have endeavored to present the reader with the information needed to understand the debates once again taking place around this important issue.

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