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At the Cato Institute Conference on
***Privatizing Social Security: Beyond the Theory*,**
Panel Discussion on "Why Privatize Social Security?"
Washington, D.C.
February 6, 2001

Reengineering Social Security in the New Economy

When I was about 14 years old, I earned my first paycheck and remember showing it to my father and asking, "Dad, what's this FICA tax?" He answered that it was the government's way to make sure that older people had an income when they retired. I remember saying, "Great! So, in effect, the government forces me to save some of my income now and then I'll get it back out with interest when I retire." My Dad responded slowly, "Well, not exactly." I said, "What do you mean 'not exactly?'"

He then briefly explained the pay-as-you-go structure of the Social Security program wherein taxes from current workers go to pay the benefits of current retirees, with nothing saved for the future. I then inquired, "Will that work?"

Well, I'm here to tell you that it won't work in the long-run if we don't do something about Social Security's current pay-as-you-go structure, especially in light of profound social, demographic, and economic changes that make Social Security an increasingly bad deal for each successive generation of retirees. Social Security is in trouble because of its basic structure and maturity as a pay-as-you-go program. During my remarks today, I'd like to focus on four topics:

* How Social Security came into existence
* Why the current system is structurally flawed
* What the implications are in the new economy, and
* Some possible solutions

Finally, I need to emphasize that I speak for myself and not necessarily for the Federal Reserve System or the Federal Reserve Bank of Dallas.

Social Security's Beginnings

Social Security seemed to start out well. Signed into law in 1935, Social Security renewed workers' confidence during the Great Depression; designed primarily to provide a continuing income after retirement. Three factors provided the impetus for this legislation: (1) the Industrial Revolution, (2) increased life expectancies, and (3) the Great Depression.

The Industrial Revolution shifted the American economy from an agricultural to an industrial base, which transformed the way people worked, where they worked, and with whom they worked. By moving from being self-employed to becoming wage earners for industrial corporations and from living with extended family and friends in rural areas to large cities, families began to worry more about their future economic security.

Increased life expectancies also helped bring passage of the Social Security Act. Americans increased their life span by 10 years as a result of improved health care programs in the early part of the 20^{th} century.

Furthermore, as America's worst economic crisis unfolded, millions of workers were unemployed, numerous businesses failed, and billions of dollars of wealth were lost in the financial markets. In a nutshell, for millions of Americans, economic security vanished and there were calls for greater government involvement to restore confidence and provide for the economic security of its citizens.

Why the Current System is in Trouble

Through the years, amendments to the original Social Security Act have made Social Security the largest and most comprehensive public program in the United States. Social Security is part of nearly every American's life and an important source of income for most of today's older Americans.

The earliest amendments effectively transformed the system into a pay-as-you-go program. That is, most Social Security taxes are used to immediately pay benefits for current retirees. As a result, Social Security is not a funded plan under which contributions are accumulated and invested in financial assets and liquidated and converted into a pension at retirement.

As an unfunded plan, Social Security gives windfall returns to the first generations of participants, since they paid in little relative to the benefits they receive, and gives below-market returns to later generations. A simple overlapping generations model (like the one described in my paper that was published last month by Cato) shows the problems of an unfunded system.

In essence, there is a start-up bonus provided to the first generation of retirees because incoming funds are immediately paid-out with no trust fund accumulations. Contributions from each working generation are used to finance benefits for the older generation in the same period. The analysis demonstrates that below-market returns from a mature pay-as-you-go scheme are inevitable as each generation is effectively forced to service the implicit "debt" issued to finance the windfall for earlier generations.

Implications in the New Economy

Today, the effects of the maturation of this flawed financing structure is further exacerbated by a gradual increase in average life expectancy and the declining ratio of workers to beneficiaries   which reduces the growth rate of the payroll tax base.

When Social Security was signed into law, life expectancy at birth in the United States was 61 years, and those who reached age 65 were expected to live another 12 years. Today, average life expectancy at birth is more than 76 years, and those reaching age 65 are expected to live an additional 17.5 years.

One decade after Social Security was established, the ratio of workers to beneficiaries was 41.9 to 1. By 1950, the ratio had fallen to 16.5 to 1. The ratio has continued to decline, dropping to 5.1 to 1 by 1960 and to 3.2 to 1 by 1975. Since then, the ratio has remained fairly steady and currently stands at 3.4 to 1 because of the large number of baby boomers in the workforce. However, with the impending retirement of the baby boomers and increased longevity, the ratio of workers to beneficiaries is expected to fall to 2 to 1 within 30 years. The inevitable result is that fewer workers will be available to support a growing number of retirees.

For Social Security recipients, the result is lower and lower below-market returns. The rate of return from year to year depends on the increase in the number of workers and in how much they pay into the system. In other words, Social Security's rate of return is merely the rate of growth of the tax base: labor force growth plus wage growth. It is these growth rates that have turned against the system.

I examined the return on contributions to Social Security through time and compared it with returns on several market-based portfolios, using three different earnings scenarios (low, medium, and high). The results show that the average annual real (inflation-adjusted) rate of return has generally decreased since Social Security's inception for all three wage levels (see figure 4 in my paper).

My calculations show that the average medium-wage earner born in 1959 can expect only a 1.85 percent annual real return from taxes paid into Social Security, which is a mere fraction of the return from a mixed stock-bond fund. High-wage earners do even worse, earning a 0.03 percent annual real return from Social Security. Even low-wage earners can expect only a 2.57 percent annual real rate of return.

Returns from market-based portfolios, on the other hand, generally outperformed the returns from Social Security contributions by a wide margin, except during the program's earliest years. By investing in stocks and bonds, wage earners could have saved more for their retirement than Social Security provides. And the gap between the returns on Social Security contributions and those on stocks and bonds has increased as the Social Security program has matured.

While the Social Security program was never intended to serve as a pure investment because it contains important social insurance elements and inflation protection, the fact remains that returns from Social Security are increasingly unattractive. Consequently, as the baby boomers retire and enjoy greater longevity, further stress is placed on the current pay-as-you-go financing plan, making it unsustainable in the long run. Even higher wage growth projections that might be expected to continue as a result of the recent extraordinary pickup in the growth of labor force productivity cannot ensure the future of the Social Security program.

I believe that attempting to fix the fundamental problems with Social Security without considering reengineering the system may only prolong the life of a flawed plan against the backdrop of demographic trends. Moreover, the longer real reform is delayed, the costlier the fix will likely be. And with the outlook for continued federal budget surpluses brought on by rising trends in productivity from the new economy, the time to act is now.

Some Possible Solutions

Reengineering Social Security must be guided by several overarching principles: (1) Greater choice and control for individuals over retirement options, (2) Incentives to save and work, thereby improving returns for future contributors, (3) Guaranteeing the long-run solvency of the system, and (4) Preserving social protections currently provided.

As you know, various ideas have been proposed to "fix" the system. The standard method of dealing with Social Security's actuarial imbalances has been to raise taxes. Tax rates and the taxable ceiling have been raised steadily through the years. Further gradual increases in the tax rate and the taxable ceiling may prolong Social Security's solvency and preserve important social protections, but the cost to future generations may soon become politically intolerable.

Another method often considered to deal with Social Security's ills is to reduce benefits. Again, these ideas may prolong Social Security's solvency, but eventually lead to lower rates of return for future retirees while failing to maintain all the protections currently provided to Social Security recipients. Moreover, these changes generally provide no or little prefunding; instead, they prolong the pay-as-you-go program without addressing the desire to increase workers' rate of return on their contributions.

My conclusion is that as long as Social Security remains a pay-as-you-go program, it will be impossible to adhere to the principles outlined earlier. Consequently, the system must be reengineered to allow for prefunding and involve some sort of privatization. I favor proposals that would transform part of Social Security into a system of individually-managed retirement accounts.

Once done, workers would not receive the system's 1.4 percent estimate future annual return but would receive the full return on the investments their accounts hold.

Historically, an account split 50-50 between stocks and corporate bonds would have received an annual return of more than 5.5 percent. Even inflation-indexed Treasury bonds, truly the world's safest investment, pay more than 3 percent annually. These higher rates of return mean that either benefits for retirees could increase or taxes on workers could fall, or both. In either case, Americans would be the winners.

But, as economists like to say, there's no such thing as a free lunch. To move from a pay-as-you-go system to a funded system we have to first put up the funds. That's why today's budget surpluses are such an opportunity. Using them, we could begin to finance the transition to personal accounts without raising taxes or cutting benefits. Over the long run, workers, retirees and the economy would be much better off.

Social Security must be modernized to take into consideration the economics and demographics of the new economy. As was the case in the 1930s, the traditional system of economic security has become increasingly unworkable. But this time, the traditional system is America's Social Security system.