

## Social Security: A Tale of Two Problems

05-04

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Those with a vested interest in the current setup of the Social Security system are holding to the strategy of, “Confusion is the best defense.”

But our social security crisis can be best understood by ignoring all the confusing “fixes” and focusing on the two distinct problems at its core.

**The first problem** is that the federal government collects more, a lot more, contributions to social security than what it needs to pay the current retirees. The excess contributions are spent on other government programs and not really saved to pay for the retirement of the workers who are making the contributions.

**The second problem** is that demographics are such that, in the future, the federal government will collect less, a lot less, in contributions than what it will need to pay the retirees of that day.

**Spending your retirement fund.** All tax receipts go into the same pot in the Treasury. Every year, far more money gets collected as Social Security payroll taxes than what is paid out. Congress simply spends it all – *on top of* what is reported as “the deficit.” All the surplus paid into Social Security over the past 20 years has already been spent.

Over the past 20 years, \$1.7 trillion in surplus Social Security taxes have been used for other programs, and in the next ten years another \$2.2 trillion will be similarly spent.

That is a lot of money, even by Washington standards. Of those \$3.9 trillion,

nothing will be saved to pay for the retirement of those making the contributions. Zilch, zero, nada, niente.

**What about the trust fund?** The Social Security “trust fund,” currently at \$1.7 trillion, contains no hard assets. It represents money the federal government owes to itself. Congress has spent the surplus money and promises to pay it back someday.

This situation is equivalent to you using your retirement savings to buy a car, and then writing an IOU to yourself and filing that in a folder called “Retirement Fund” in a safety deposit box at the bank. The following year you do the same to pay for your vacation. You pay for your kids’ college education the same way. Every year you assure your spouse that your joint retirement fund is growing, safe and secure, in a lock-box. If you tear up those pieces of paper, it has no economic impact.

Former Chrysler Chairman Lee Iacoca once said that any CEO who tried this with a firm’s pension fund would be thrown in jail.

David Walker, head of the Government Accountability Office (GAO) said recently of the trust fund: “...it doesn’t have any economic significance whatsoever. There are no stocks or bonds or real estate in the trust fund. It has nothing of real value to draw down.”

When a new federal bond is issued, it is printed on an office printer at the Bureau of the Public Debt in Parkersburg, West Virginia. Someone then carries it across the room and puts it in a fireproof filing cabinet. That filing cabinet is your Social Security trust fund. If you tear up those pieces of paper, nothing changes economically.

According to the Office of Management and Budget (OMB), there are only three ways Congress can repay these bonds: raise other taxes, authorize the Treasury to borrow more, or reduce spending on other federal programs.

**The end of the Baby Boomers.** The second problem with social security is that demographics are such that the big surplus will turn into a *huge* deficit.

The current social security system is structured like those infamous pyramid schemes. Workers do not pay for their own retirement; those coming behind will pay for it. As long as the ratio of workers to retirees remains constant (and large) it is cheaper than saving for your own retirement. By cheaper we mean that you get a better rate of return than alternative forms of saving.

But Americans are living longer and having fewer children, and this alters the ratio between the number of workers and retirees. In 1937, 42 workers paid 2% in payroll tax to support every retiree. In 1950, 16 workers paid 3% in tax for each retiree. Today around 3.3 workers pay 12.4% in payroll tax for each retiree. By 2025 there will be two workers per retiree and by 2050 1.3 workers per retiree.

Also, the retirement age has been slowly pushed out, meaning that you contribute more money for a longer period, further eroding the rate of return.

Social Security has become a poor deal for workers. When the program started in 1935, the rate of return on a 40-year worker's investment was about 8%. Today someone that age can expect a dismal 1%. Our children's rate of return will be negative if the program remains the same. But it can't stay the same, it can only get worse.

Elected officials are currently proposing many confusing "fixes" to deal with this crisis. Some examples are raise payroll taxes, raise the level of income subject to tax, decrease the rate of benefit growth, tax benefits, and raise the retirement age again.

These changes fix nothing fundamental. They do nothing to address the first problem; they simply delay the inevitable with regards to the second problem, and they further erode the rate of return on retirement contributions.

**Back to the future.** Private savings accounts are the only solution being discussed that goes to the core of these problems. It proposes to fix the second problem by fixing the first.

Private accounts, in essence, move some of the burden of supporting future retirees to current workers (to the future retirees themselves) and go to the core of the problem (change the ratio of workers to retirees).

The federal government has no mechanism to save the huge amounts of money needed. The surplus funds cannot be simply put in a mattress – they have to be put back into the economy. Today they are put back into the economy by paying for some other government programs. With private accounts they will be put back into the economy by buying real assets that belong to the future retirees.

**So what's the hitch?** If this is such a good idea, why do so many people oppose it?

The biggest reason is we have gotten used to spending our retirement funds now. If you decide to stop writing IOUs to yourself and start putting real assets into your retirement fund, how are you going to pay for the new car, the vacations, the kids' college?

The status quo means Congress will spend the surplus \$2.2 trillion of the next ten years, keep writing those IOUs and reassuring us that our trust fund is safe in that file cabinet in West Virginia.

Personal accounts, on the other hand, are the way to make sure our retirement funds are worth more than an empty promise in a lock box.