Social Security Retirement Income Program: Reform vs. Privatize

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Abstract

This paper compares recommended reforms to improve the Social Security retirement income program to the expected benefits of privatizing it. The research method is primarily theoretical, applying fundamental principles of finance and economics to analyze and evaluate each alternative. However, enough empirical data is also provided to test the author's arguments and conclusions. The most important conclusion is that partial privatization would be better than the other recommended reforms, but a fully-funded and totally privatized program would be best, financially and economically for society. However, given government policymakers' lack of political will to privatize the program, it's most likely that they will continue to reform it in ways to make it more financially sustainable. The paper primarily adds to the existing literature by providing a strong theoretical and empirical argument for privatizing the Social Security retirement income program, rather than continuing to reform it.

I. Introduction

This paper explores whether it's better to continue to reform the Social Security retirement income program or privatize it. That's an important research question for most U.S. workers and their employers who help pay the FICA (Federal Insurance Contribution Act) taxes to finance the projected retirement benefits. Most Americans either currently receive or expect to receive monthly retirement income checks from the Social Security Administration during their retirement years.

The author of this paper believes he has a comparative advantage in researching this topic, as a financial economist experienced in teaching both public finance and personal financial planning, and being old enough to file for Social Security retirement income benefits. This is a research topic that the author has explored for several decades. Even though this paper analyzes, evaluates, and recommends changes in this important government program, the author is not politically motivated, and doesn't believe his research is politically biased. The author highly values his academic integrity. The author recognizes that any recommended changes in this important government program will be controversial and worthy of additional research and honest debate. Currently, neither the Democratic Party nor the Republican Party favors either partial privatization or complete privatization of this important government program.

The author uses fundamental principles of finance and economics to analyze and evaluate recommended reforms, partial privatization, and total privatization of the Social Security retirement income program. Research data is presented which provides empirical support for the theoretical arguments and conclusions. The paper also introduces political considerations, which are important to the government policymakers who have to make these public finance decisions. In campaigning for their political office, most candidates have pledged to "save" Social Security, which means they won't privatize it. A widely-held view is that voting to cut Social Security benefits would be the third rail of politics -- the end of your political career.

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Private sector failure, as evidenced by the fact that many people have not saved enough to keep themselves out of poverty throughout their projected retirement years, justifies some government policy efforts to improve market conditions. However, public sector financial assistance, in the form of supplementing households' retirement income, creates the moral hazard problem of increased private sector dependence on public assistance. The more the government promises to provide in retirement income, the less individuals save during their working years for their own retirement. As the government taxes away workers' income to save for their retirement, it crowds out their saving for retirement in the private sector. Compared to other developed OECD (Organization for Economic Co-operation and Development) countries, U.S. households' saving rate out of disposable personal income is relatively low (Feldstein, 2008). Most Americans are not saving enough to finance their pre-retirement lifestyle during 20-30 years of retirement, without receiving Social Security retirement income.

To be economically efficient, market participants need to be rational, self-interested, and forward-looking. To be forward-looking, our Social Security retirement income program needs to be financially sustainable for future generations. Currently, it's a pay-as-you-go system that is not fully funded and not financially sustainable. Consequently, there is substantial political risk that retirees' could have their Social Security retirement income benefits cut prior to their retirement or during their retirement years. There is also significant risk that FICA taxes will be increased in the future on employees and employers. Government policymakers will also most likely increase the percentage of Social Security retirement income that is taxed, in an ongoing effort to raise enough tax revenue to make the program financially sustainable.

The Social Security Trust Funds are totally invested in U.S. government bonds; so future payments are dependent on the government's ability to pay its debt obligations. However, the U.S. government budget has a large budget deficit of about $1 trillion in 2012 and a national debt of about $15 trillion, approximately equal to the U.S. gross domestic product (GDP). The U.S. government is currently forecasting that its national debt will increase by about $8 trillion over the next ten years, growing faster than the U.S. economic growth rate, thereby increasing the U.S. government's debt/GDP ratio, and increasing its default risk (Riley, 2012). Its credit rating was downgraded in 2011, with a negative outlook. Future credit downgrades would most likely increase the interest rate cost of financing its national debt.

The failure of government intervention to achieve its economic and financial goals demonstrates public sector failure. Although the Social Security retirement income program provides valuable benefits to retirees, the program in its current form is not financially sustainable. While making the reforms recommended by this paper would improve it, this paper argues that it would be better to partially privatize it, and best to fully-fund and totally privatize it.

The next section of the paper provides a review of the literature, followed by recommended reforms, including partial privatization. The subsequent subtopic highlights the expected benefits of total privatization, followed by the author's conclusions, and references of researched sources.

II. Literature Review

Limiting the government to laissez-faire policies in a competitive market economy is best, in the absence of substantial market failure. Laissez-faire policies authorize the government to do what it does better than private sector market participants. Redistribution of income and wealth is not a laissez-faire policy. Competitive markets are best at distributing most resources, products, income, and wealth to meet the needs and wants of most households and businesses. In principle, a competitive market economy is largely self-regulating, operating without the need of substantial government regulation, in the absence of substantial market failure (Johnston, 1988; Friedman & Friedman, 1980). These fundamental economic principles suggest that it would be better for most Americans to voluntarily save and invest for their own retirement and manage their own retirement income cash flows than to have the U.S. government force them to save for retirement by paying FICA taxes, then have the government invest their money in government bonds, to provide them a single life annuity retirement income, based on the government bureaucracy's management of the collectively pooled and redistributed Social Security funds.

On the other hand, private sector failure justifies some public sector intervention to improve market conditions to maximize social welfare – the economic well-being of most market participants (Congleton & Bose, 2010). While having a Social Security retirement income program is not economically ideal or optimal; the law of second best suggests that when the market conditions don't meet the requirements for achieving the best solution, the second best solution should be used, but the second best solution could be quite different from the best solution (Bosetti & Victor, 2011). Currently, the high dependence of the elderly on Social Security retirement income suggests that it should be continued to reduce poverty among the elderly, as a second best solution, because many retirees have not accumulated a large enough nest egg to finance their retirement years independent of this government program, despite their opportunity to contribute to a variety of tax-sheltered retirement accounts, including 401(K) accounts and Individual Retirement Accounts (IRA). Most future retirees will not have a defined benefit pension funded throughout their lifetime of work for a single employer to help finance their retirement. The Social Security retirement income program was started by the Social Security Act of 1935. Today, Social Security is the largest source of retirement income for the average American. It is expected to provide between 40% and 60% of pre-retirement income for most individuals who worked until their full retirement. It is not expected to provide all the retirement income needed by most retirees (Gitman & Joehnk, 2005).

However, public sector intervention is typically accompanied by public sector failure, as explained by public choice theory (Couch, Burton, Malone, & Black, 2011). Government policy attempts to improve market conditions often fail to achieve their policy goals. While businesses and individuals in the private sector sometimes fail to do what's best economically and financially for themselves and society; government policy attempts to fix the problems are often inefficient and unfair. Consequently, some market failure usually persists, despite government intervention. Some failed government attempts to improve market conditions could worsen them. The Social Security retirement income program demonstrates public sector failure to improve on private market conditions, because it would be more efficient and fair for each individual to manage their own finances, including their retirement savings, investments, and distributions. In principle, the decentralized decision making by millions of individuals with the

help of their professional financial advisers, to achieve their individual retirement goals is better than the centralized decision making of the U.S. government, even when it is trying to do what the government believes is best for most individuals.

In 1983, during the Reagan Administration, the Greenspan Commission recommended over 20 changes to the Social Security's retirement income (i.e., old age) program. The recommended reforms included, a gradual increase in the full retirement age, a small increase in the FICA tax rate for both employees and employers, taxing the Social Security retirement income of higher-income households, an increase in the credit for each year a retiree delayed filing for SS benefits from 3% to 8%, a change in the calculation of inflation-adjustments to retirement income benefits, removing the Social Security Trust Funds from the unified budget, and making the Social Security Administration an independent agency of the U.S. government (Greenspan Commission, 1983; Blahous, 2010).

During the Clinton Administration, the 1994-'96 Advisory Council Report recommended three alternative reforms of the Social Security retirement income program (1996). The first was called a maintenance of benefits (MB) plan; it raised taxed revenue, as needed to maintain the program's financial solvency. Some of the funds could be invested in common stocks indexed to the broad market, to increase the portfolio return at a manageable level of portfolio risk. The second was called an individual accounts plan (IA), with an additional FICA tax to finance the supplemental account. These funds could be allocated to a limited range of government approved investments. Retirement income would be paid out as a life annuity. The full retirement age would be gradually increased. Social Security benefits would be reduced for middle-income and high-income retirees. The third was called a personal security accounts (PSA) plan, funded by about one-third of FICA tax revenue. Each individual PSA account owner could invest their funds privately, as desired, including equity investments, and have a variety of payout options in retirement. These funds would not need to be paid out as a single life annuity. The age at which retirees could first collect monthly retirement income payments would be gradually increased from 62 to 65. The modified retirement benefit would be reduced, and reduced more for some retirees, including dependent spouses. Taxes on retirement benefits would be increased.

In 2001, President Bush formed a commission to recommend reforms to the Social Security programs. "The Commission was asked to make recommendations to modernize and restore fiscal soundness to Social Security, using six guiding principles (2001 President's Reform Commission):

1. Modernization must not change Social Security benefits for retirees or near-retirees.
2. The entire Social Security surplus must be dedicated only to Social Security.
3. Social Security payroll taxes must not be increased.
4. The government must not invest Social Security funds in the stock market.
5. Modernization must preserve Social Security`s disability and survivors insurance programs.
6. Modernization must include individually controlled, voluntary personal retirement accounts, which will augment Social Security."

The first paragraph of the executive summary of the commission's reports highlights some of the most important expected benefits of having voluntary personal accounts in the Social Security retirement income program.

> "Social Security will be strengthened if modernized to include a system of voluntary personal accounts. Personal accounts improve retirement security by facilitating wealth creation and providing participants with assets that they own and that can be inherited, rather than providing only claims to benefits that remain subject to political negotiation. By allowing investment choice, individuals would be free to pursue higher expected rates of return on their Social Security contributions. Furthermore, strengthening Social Security through personal accounts can add valuable protections for widows, divorced persons, low-income households and other Americans at risk of poverty in old age (Report of the President's Commission to Strengthen Social Security, 2001)."

The independent accounts and individual personal security accounts recommended by President Clinton's commission and the voluntary personal retirement accounts recommended by President Bush's commission represent partial privatization. However, neither of these recommendations has become part of the Social Security retirement income program to date.

One possible concern with the recommendations of these presidential commissions is that they could be politically biased in favor of the President who appointed them. However, the author of this paper doesn't find any clear evidence of that. Many of their recommended reforms of the Social Security retirement income program are similar for commissions appointed by both Democratic and Republican Presidents. Most of their recommendations have not been implemented by the government.

"In the 2009 Annual Report to Congress, the Trustees announced:

- The projected point at which tax revenues will fall below program costs comes in 2016 -- one year sooner than the estimate in last year's report.
- The projected point at which the Trust Funds will be exhausted comes in 2037 -- four years sooner than the estimate in last year's report.
- The projected actuarial deficit over the 75-year long-range period is 2.00 percent of taxable payroll -- up from 1.70 percent in last year's report.
- Over the 75-year period, the Trust Funds would require additional revenue equivalent to $5.3 trillion in today's dollars to pay all scheduled benefits (Lassiter, 2009)."

The 2009 annual report of the Social Security Trustees is the last report published on the Social Security Administration's website. One wonders when these "annual" audit reports will be published for 2010 and 2011! The U.S. government requires public corporations to publish their annual reports each year, but it doesn't hold itself to the same financial reporting standard. The audit reports for recent years show that the Social Security retirement income trust fund will soon have an annual budget deficit and will be "exhausted" in about 25 years. Trillions of additional dollars would be needed to make the program financially sustainable for the next 75 years (Lassiter, 2009). In brief, this public pension fund is massively under-funded, despite many recommended reforms in recent decades. The U.S. government would not permit a large public company to under-fund its defined benefit pension fund by so much, but the government

doesn't hold itself to the same high financial management standards it requires of these private companies.

President Obama has promised to maintain current Social Security benefits for current and future generations of retirees. He favors continuing to invest Social Security trust funds in U.S. government bonds. He opposes proposals to privatize this government program (Obama, 2012).

Mitt Romney was the Republican candidate running against President Obama in the 2012 election for U.S. President. His campaign proposed only two changes to Social Security's retirement income program to make it financially sustainable for the projected future.

"Mitt's proposals will not raise taxes and will not affect today's seniors or those nearing retirement. He proposes that Social Security should be adjusted in a couple of commonsense ways that will put it on the path of solvency and ensure that it is preserved for future generations.

- First, for future generations of seniors, Mitt believes that the retirement age should be slowly increased to account for increases in longevity.
- Second, for future generations of seniors, Mitt believes that benefits should continue to grow but that the growth rate should be lower for those with higher incomes (Romney, 2012)."

III. Recommended Reforms to Achieve a Financially Sustainable Program

- Increase the Retirement Age: from 67 to 70, adjusted to changes in life expectancy. For anyone born in 1960 or later, the normal retirement age is 67, to receive full retirement income benefits. Reduced monthly income payments are available for those choosing to retire as early as age 62. A retired spouse could either claim benefits based on her or his own income or receive 50% of their husband's or wife's monthly benefit. A surviving retired spouse or one with dependent children could either continue to receive their own benefit or elect to receive the monthly retirement income of their deceased spouse, plus a lump-sum death benefit of several hundred dollars (Gitman & Joehnk, 2005).
- Increase the Tax Rate: FICA tax rate and/or the tax rate on benefits received. In 2010, an employee and employer each paid 7.65% of the employee's wage in FICA taxes, up to a maximum wage income; 1.45% of this was for Medicare (Your Social Security Statement, 2012). Workers who start collecting Social Security retirement income prior to their full retirement age will lose $1 in benefits for every $2 in earned income above the annual income limit ($11,520 in 2003), until they reach their full retirement age. Since 1984, 50% of Social Security retirement income is subject to federal income taxes for middle-income households; 85% is taxable for higher-income households (Gitman & Joehnk, 2005).
- Raise the cap on taxable income: The maximum wage income was $87,000 in 2003; this taxable wage base increases each year (Gitman & Joehnk, 2005). In 2011, wage income was taxable up to $106,800 (Your Social Security Statement, 2012).
- Invest in a Higher Risk & Higher Return Diversified Portfolio of Stocks, Bonds, and Money Market Assets: Just investing in U.S. Government bonds inefficiently provides

too low a return with too little risk, and creates a principal-agent, problem that could prove costly to future retiree principals (Philips & Muralidhar, 2008).

- Reduce the Projected Monthly Income Benefit, to Adjust to an Increasing Life Expectancy.
- Use a Lock Box for the Trust Fund of Tax Revenue and Investment Income: Separate the funds from the U.S. government's unified budget.
- Change from a Pay-as-you-go System to a Fully-Funded Pension System: Currently, there are no government assets to pay off maturing government bonds in the Social Security Trust Funds. The government did not invest the Social Security surplus of past decades in non-government assets it could sell to pay its financial obligations to retirees. That inefficient financial management is consistent with the public choice theory of public sector failure.

IV. Expected Benefits of Privatization

- No FICA Tax for Employees and Employers: There would be no forced retirement savings. Since individuals are rational, self-interested, and forward-looking, they vary their saving rate in different stages of their life, per the life cycle hypothesis of saving and consumption. If the combined employee and employer FICA tax on wage income were eliminated, most workers would be willing and able to increase their saving rate, thereby saving more for their future retirement.
- No Political Risk of Unexpected Tax Increases and Benefit Cuts: If not privatized, one possible reform is that benefits could be means-tested, cutting out benefits for higher income and wealthier retirees (Hogler & Hunt, 2010).
- No Entitlement Program Responsibility for High U.S. Government Budget Deficits and Debt: Entitlement programs, including Social Security programs, are now predicted to create a financially unsustainable trend increase in U.S. budget deficits and debt.
- No Redistribution of income and Wealth: There would be no more distributions to non-contributors (Kotlikoff, 2011). That would be an efficiency improvement, per the principle of fairness and per the benefits-received principle of taxation. A retiree's Social Security monthly retirement income benefit is based on his or her average annual income throughout their working age years. However, the benefit formula provides a higher benefit per dollar earned to lower-income retirees. Consequently, earning twice the average annual income won't double the monthly retirement income benefit from Social Security (Gitman & Joehnk, 2005).
- No Government Control over Retirees' Retirement Age, Contributions, and Withdrawals: Replacing government control over household finances with personal control would be an important efficiency improvement.
- A Larger Nest Egg and More Retirement Income (Johnston, 2011; Johnston, 2009): Investing individually, with the help of professional financial intermediaries, would enable investors to maximize returns within the risk tolerance of each investor, using an internationally diversified investment portfolio.
- A Larger Estate for Heirs (Johnston, 2011): Social Security only provides a single life annuity and only for those who survive to retirement age; its death benefit is insignificant and its survivor's benefit is only for a surviving spouse who still has dependent children. Privately managed retirement funds, including pension funds, have many payout options,

including options where some or all of the capital is preserved for a retiree's heirs. If privately managed, when a retirement investor dies before retiring, his or her funds are distributed to their designated beneficiaries.

- More Individual Freedom and Responsibility in a More Efficient and Fair Market Economy with Less Inefficient Government Intervention: That would be a better form of market Capitalism, with more of a laissez-faire government and a more competitive free market economy that is more self-regulating, which would benefit both retirees and society, per the invisible hand principle.

V. Conclusion

Compared to respected pension fund companies, such as Fidelity, Vanguard, Charles Schwab, TIAA-CREF, MassMutual, and many others, the U.S. government is a relatively poor financial manager of retirement funds. Rather than taking voluntary contributions, retirement funds are created by a forced saving plan, using FICA taxes, required by law. The government faces no competition for these funds, so it doesn't have to be competitive with private financial firms.

Rather than investing the funds in an internationally diversified portfolio to maximize the returns at a manageable level of risk for each contributor, the funds are entirely invested in U.S. government securities, which are low-risk and low-return assets. Since the government is both the only seller of its debt securities and also a buyer of them for the Social Security programs, it has an inherent conflict of interest, which could lower the future value of these investments; that demonstrates a principal-agent problem that could be costly to future retiree principals. Through its monetary policies, the U.S. government also controls the purchasing power of the U.S. dollar, in which its debt securities are denominated. Although projected benefits are indexed to inflation, the inflation index used to adjust Social Security benefits is not the same as the overall total consumer price index (CPI) measure that best measures the inflation rate borne by consumers.

Rather than keeping the funds in individual accounts, the funds are pooled and the retirement income benefits are designed to redistribute income to lower-wage households, to dependent spouses who haven't made tax contributions, and to survivors, thereby providing a negative return to the highest-wage workers.

Unlike distributions from private pension fund companies, the projected distribution of Social Security retirement income benefits is also exposed to substantial political risk, since the government could decide at any time to reduce the projected benefits to meet other political goals, such as the goal reducing the U.S. government's budget deficits and national debt.

Reforming the Social Security retirement income program will not fix these fundamental problems. Consequently, partially privatizing the Social Security retirement income program would be better than other recommended reforms, from an economic and financial perspective. Fully funding and entirely privatizing it would be best. However, what's best economically may not be best politically. In recent decades, those political leaders who have tried to partially privatize it have failed to get their recommendations implemented in law. Currently, neither

political party favors either partial privatization or complete privatization of this program. The government has not had the political will, courage, and fiscal discipline to do what is best economically and financially for society for the long-term projected future. Using a crisis management approach, government policymakers continue to kick the can down the road by incrementally reforming the Social Security retirement income program just enough to keep it alive, in the name of "saving Social Security".

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