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GUEST COMMENTARY



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## **SOCIAL SECURITY:** No longer a notably productive investment

Is Social Security going bankrupt? The best answer may be: On paper, yes; in reality, no. How can this be?

According to the 2000 Report of the Social Security Board of Trustees, Social Security is adequately financed through 2037, at which point it will pay roughly 72% of benefits unless it obtains additional funds.

Social Security, which consists of Old Age Security (retirement program) and Disability Income (disability program), is funded by a 12.4% payroll tax (half of it assessed on the employer and half on the employee).

The report estimates that if this payroll tax were raised to 14.29%, Social Security would be adequately funded through the 75-year projection period.

Let us offer this translation: If we do nothing to fix it, Social Security will become slightly bankrupt in 2037. But this will really not happen.

Social Security tax receipts exceed its expenditures, and this extra money is borrowed by the federal government. Eventually, expenditures will exceed income, at which point, we suggest, Social Security should just turn around and ask the feds for a loan, too.

This might sound strange, but it is not — this has happened in other countries. Many countries pay a subsidy to the social security system, without counting this as a loan. We can safely assume that Social Security benefits are guaranteed by the federal government.

If anyone is really scared about solvency of Social Security, they should think twice before buying Treasury bills or Treasury bonds. After all, they would be dealing with the same, presumably unreliable, creditor.

Is there a problem then? Yes, but it is of a somewhat different nature.

Social Security is important. It is the main source of retirement income for many Americans. Roughly a third of today's seniors depend on Social Security for more than 90% of their retirement income.

**SOCIAL SECURITY** was a good investment for early participants.

The first generation of participants received a windfall. They did not pay the payroll tax, but received benefits.

However, there was a longer term phenomenon of this nature, too. The average annual rate of return to all Social Security retirees has been roughly 8% above inflation.

To make a proper comparison, one should recall that the average annual return on stocks in the 20th century was in the range of 7% above inflation.

If this does not sound impressive, we should note that finance researchers still cannot explain the so-called "equity premium paradox": the fact that returns on stocks are so much higher than returns on bonds (in the range of 5% annual difference or better). In oth-

er words, 7% after inflation is pretty good. And 8% after inflation from a program fully backed by the United States government is phenomenal!

Not everyone received such a high return on their Social Security contributions, but this is the average for current retirees. Many received even a better deal. No wonder Social Security is so popular among seniors.

Such a performance cannot be repeated. Great returns were produced by two developments: increases in the payroll tax and increases in the coverage of workers.

**WHEN SOCIAL** Security started in 1935, the tax rate was 2% (split evenly between the employer and employee). Over time, it has increased sixfold. The system originally covered only about half of the workers. Now it covers virtually all.

This doubling of the coverage of the population and the sixfold increase in the tax rate have given Social Security a continuously increasing inflow of funds, which in turn provided it with an opportunity to increase benefits.

If we adjust the rate of return on Social Security contributions for the tax and coverage increases, the historical rate drops to roughly 2.3% after inflation, comparable with other investments enjoying U.S. government guarantee.

In fact, if the current system raises taxes or cuts benefits to cover the existing long-term financing gap, the rate of return to future retirees may become as low as 1.5% after inflation.

This is the crux of the problem. For current generations, Social Security has become a bad deal.

We can buy inflation-protected U.S. bonds paying roughly 3.5%. Despite a big drop in the stock market in 2000, in the long run stocks are likely to return at least 7% after inflation (the return on private capital in the U.S. corporate sector is even higher now, near 8%, and that rate averages over bonds and stocks, with bonds generally providing a lower return).

This is precisely why President Bush's proposal to allow workers to invest a part of their payroll taxes in government bonds or private markets is quite well received among younger Americans.

To provide the same returns as it did historically, Social Security would have to raise its payroll tax over the next 75 years to roughly 78%. Some former and current communist countries have tried this approach, but it is truly undesirable.

It is better to look at the alternative of individual investments.

For many poor workers this may be the only opportunity to participate in the wealth-creation process of private enterprise, as they have no other savings to invest on their own. This may be their fighting chance, which current Social Security can no longer afford to be.