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Social Security Revisited: A Plan to Fix It

This essay was originally published in January 2001 and was updated in January 2005. It is a follow-up essay to "Social Security by the Numbers."

In the prior essay ("Social Security by the Numbers") we looked at Social Security from the point of view of the individual, specifically, "How much did I pay into it?" and "What can I expect to get out of it?" Our essay resulted in a number of comments and questions. In order to address these questions, we need to review Social Security in the aggregate—that is, what does the whole program look like?

In Figure 7.4 we've plotted the following for each year since 1940:

1. The number of dollars workers paid into the program in taxes.
2. The number of dollars retirees received from the program in benefits.
3. The resulting assets in the "trust fund."

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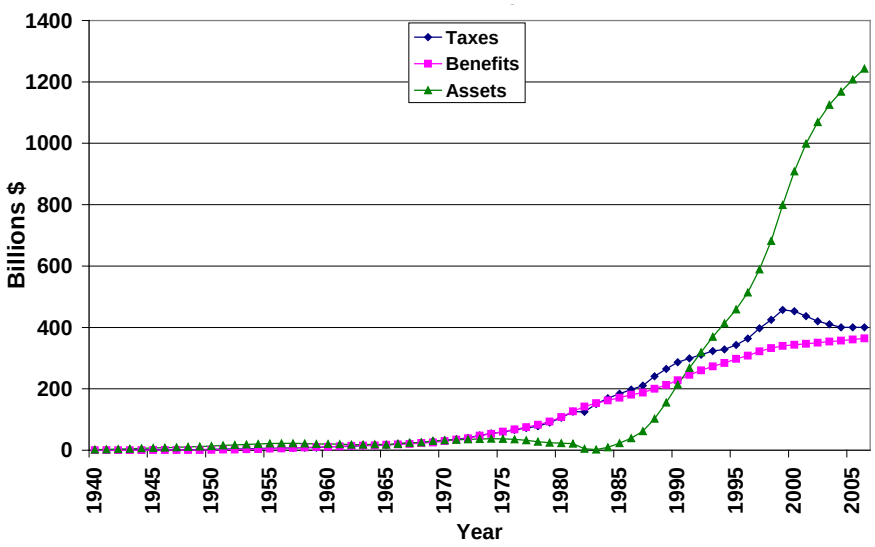
Figure 7.4 The Social Security Program Financial Status, 1940-2005



Source: Information derived from www.ssa.gov.

As you can see, the program currently looks pretty good. There is close to $1.2 trillion in the trust fund, roughly three years worth of benefits. This looks impressive until you realize that most people receive benefits for 20 years, not three.

Most of you know that we don't like to make projections, but in the case of Social Security, it's pretty easy.

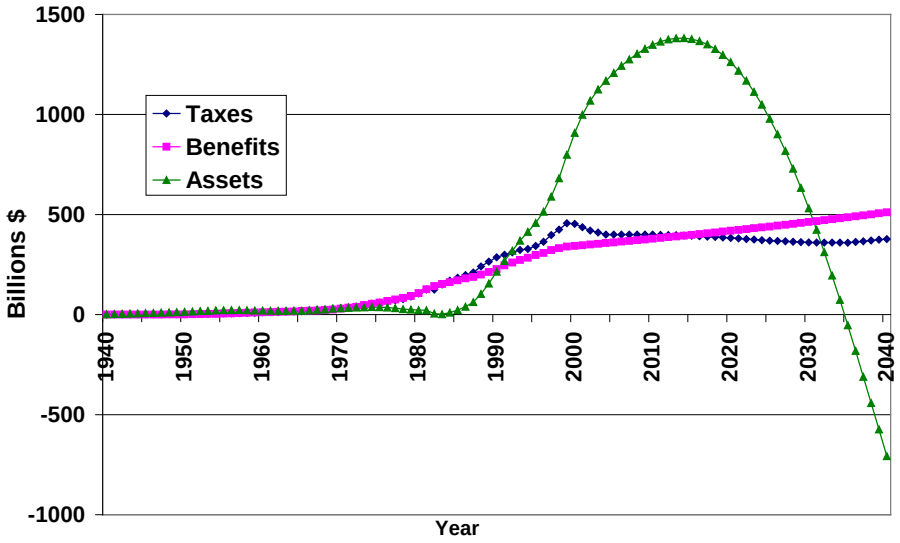
The benefits to be paid out each year will equal the number of retirees multiplied by the benefits promised to them.

The taxes paid in each year will equal the number of eligible workers, multiplied by the employment rate, multiplied by the withholding rate on their salaries up to a stated level.

Since nearly all the future retirees are already in the workforce and nearly all the eligible workers for the next 20 years have already been born, it's fairly easy to project the taxes, benefits, and assets for the next 20–40 years. In fact, our projections look just like the projections of the Social Security

Administration (SSA). The projections are included in Figure 7.5, which shows why today's retirees over the age of 65 don't have a problem; there will be sizable assets in the program for the next 30 years.

Figure 7.5 The Social Security Program – Projected Finances



Source: Information derived from www.ssa.gov.

But Figure 7.5 also shows why the children of today's retirees, people ages 30 to 40, do have a problem: the program runs out of money in 2035.

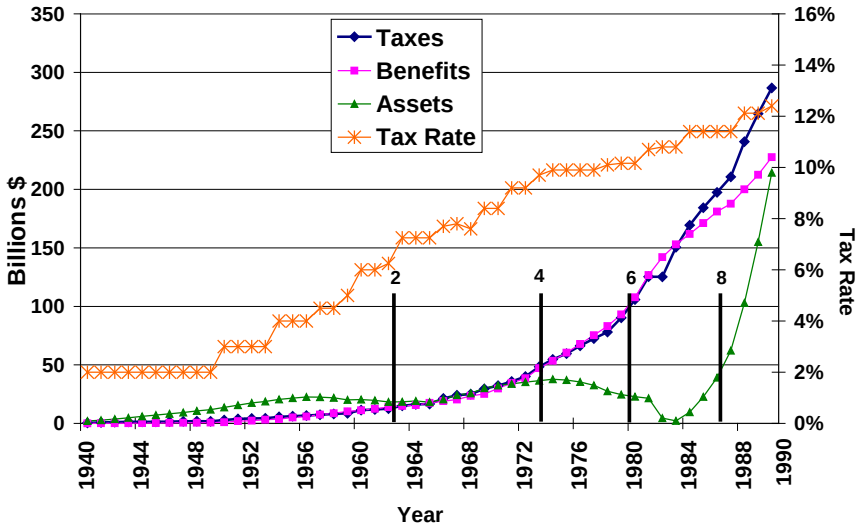
Why has the program worked so far? When the Social Security program was initiated in 1937, the average life expectancy in the United States was less than 65 years. Eligibility for benefits was set at age 65 in the expectation that fewer than half of the workers would collect Social Security (because they wouldn't live long enough). Furthermore, when the program started, there were a lot of workers paying into the program and few receiving benefits.

In 1945, the ratio of workers-to-retirees was over 40 to 1; in 1950, over 16 to 1; and in 1960, the ratio was 5 to 1. Today, the worker-to-retiree ratio is a little over 3 to 1.

As the worker-to-retiree ratio fell, the SSA found it necessary to raise the tax rate from 2% in 1937–49 (1% employee + 1% employer), to 6% by 1960, to 12.4% in 1990. The 12.4% rate remains today.

Furthermore, the SSA found it necessary to raise the level of wages on which the tax is paid from $3,000 in 1937 ($38,400 in 2004 inflation-adjusted dollars) to $87,900 in 2004.

Figure 7.6 The Social Security Program, 1940-90

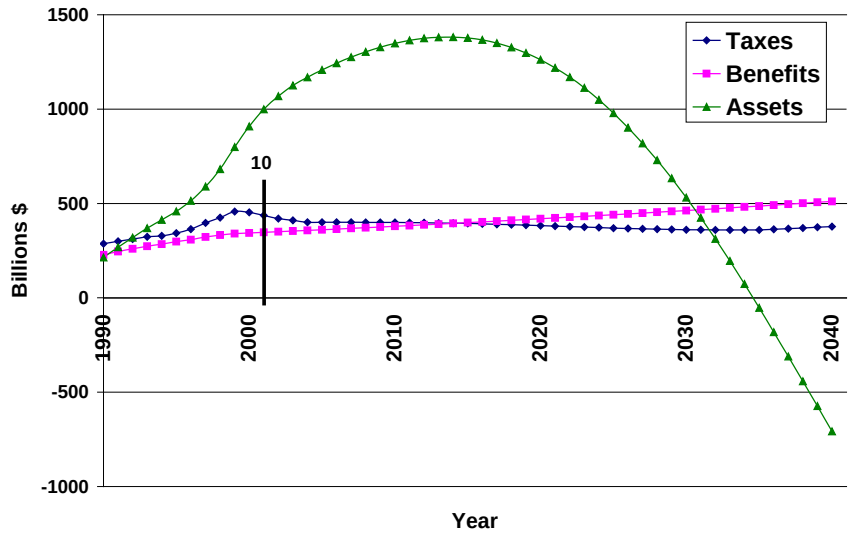


Source: Information derived from www.ssa.gov.

We've plotted the applicable tax rate on Figure 7.6. We've also marked the years when the combination of tax rate and rate base first pushed the top payer over the levels of $2,000, $4,000, $6,000, $8,000, and $10,000 (all numbers inflation-adjusted).

Note that Figure 7.7 is a continuation of Figure 7.6, simply with a change in scale.

Figure 7.7 The Social Security Program, 1940-2040



Source: Information derived from www.ssa.gov.

Also, starting in 1984, the Social Security Administration started cutting the value of retiree benefits. In 1984 they started taxing benefits; they started taxing 50% of the benefit and now tax 85% of the benefit. More recently, they've been raising the retirement age.

I was born in 1944; the age for me to qualify for full Social Security benefits is 66 years, not 65. If you were born in 1960, the age at which you will qualify for full benefits is 67 years, not 65.

Social Security benefits are calculated as a percentage of your qualifying pay prior to retirement. Currently, benefits are calculated at 90% of the first $627 of one's average indexed monthly earnings; plus 32% of one's average indexed monthly earnings over $627 and through $3,799; plus 15% of one's average indexed monthly earnings over $3,779. Since the average wage earner today earns roughly

$34,731 per year ($2,894 monthly), the average retiree is promised benefits a little over 45% of their pay. See Figure 7.8 for details.

Figure 7.8 Social Security Benefits

	Monthly	Annual
Average Wage per SSA 2003	$2,894	$34,731
SSA Benefits Calculation:		
90% of $627, plus	$564	$6,772
32% of earnings > $627 through $3,779 plus	$726	$8,706
15% of earnings > $3,779	$0	$0
Total	**$1,290**	**$15,478**
% of current wage	**45%**	**45%**

Source: Information derived from www.ssa.gov.

Three people each paying 12% in taxes can support one person taking 36% out in benefits. (Note that in 1960, five people each paying 6% in taxes could support one person taking 30% out in benefits.) The problem is that the ratio of workers to retiree will decline to just 2:1 by 2030.

At that point, the two workers would each have to pay 18% of their pay (nearly a 50% increase) into Social Security in order for one retiree to receive 36%. Some people believe this is a viable solution. I don't. In the 1970s, I saw what happens when people are pushed into ever-higher tax brackets. At some point, they quit working. Even if the employees want to work, if the employer quits, the employees are out of work.

A second solution is to cut benefits. (In fact, I've suggested cutting the benefits of millionaires, but there aren't enough millionaires to solve the problem.) Many retirees believe that their benefits can't be cut. They believe they're entitled to the promised benefits. But the Supreme Court (*Fleming v. Nestor*, 1960) has ruled that we're not entitled to the promised benefits. Some retirees were shocked when Medicare tripled the amount (from $10 to $30) of the co-pay for prescribed drugs. Folks, the rules on Social Security are set by the same people who make the rules on Medicare. If they believe it is necessary, they will cut your benefits.

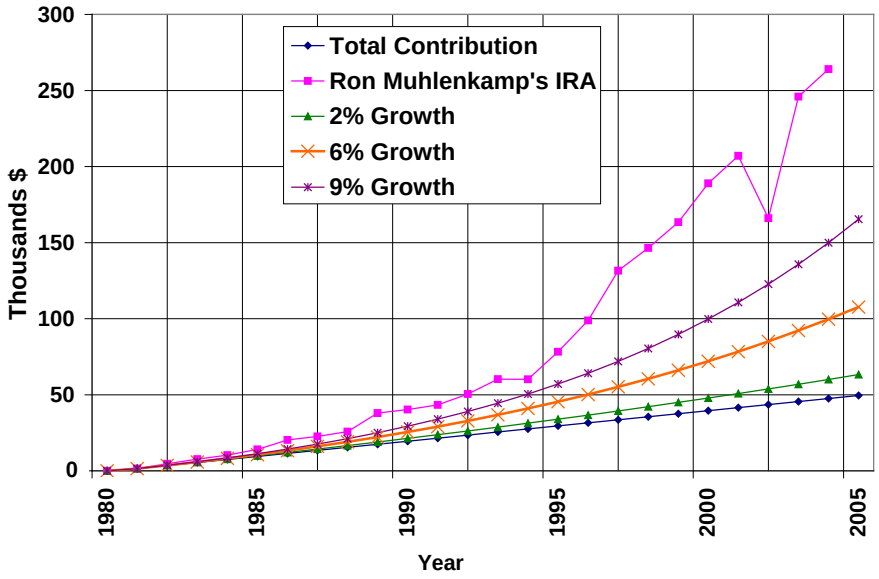
But there is a third way to make Social Security viable for the next generation.

If a part of the taxes used to build the trust fund for the next 30 years could be invested to earn a reasonable rate of return, we could alleviate the problem. Some have suggested allowing people to invest

part of their Social Security taxes in a Personal Security Account. To me, a Personal Security Account sounds a lot like an IRA (call it a PSA). So I took a look at my IRA to see how it has done.

Figure 7.9 is a plot of my personal IRA from 1981 through 2004. The bottom line is the total dollars I've paid in—$1,500 in 1981 plus 23 years multiplied by $2,000 per year is equal to $47,500. The middle lines are calculated: they show the assets I'd have if I'd earned 2%, 6%, or 9% per year. The top line is what my account has actually done. Figure 7.10 simply extends Figure 7.9 out another 20 years to show a typical working lifespan of 44 years.

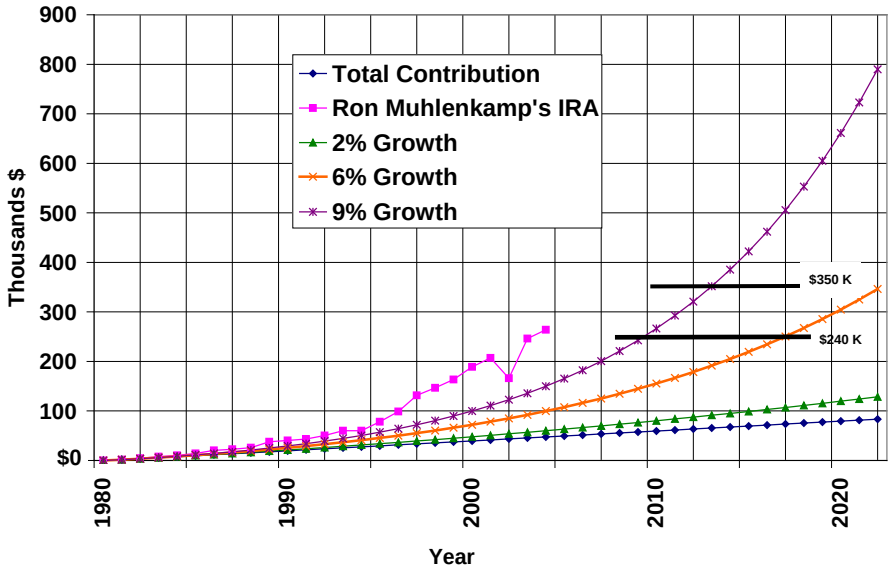
Figure 7.9 Ron Muhlenkamp's IRA



Source: Muhlenkamp & Company, Inc.

The Social Security Administration recently sent me a statement that said my promised benefit upon retirement is $21,924 per year. The IRS says my life expectancy at age 66 is 16 years. So the SSA expects to pay me $350,784 over my retirement years. We've marked that on Figure 7.10

Figure 7.10 IRA Projections



Source: Muhlenkamp & Company, Inc.

Alternatively, an annuity that promised me $21,924 for 16 years would cost $240,000 at the start, if we assume an interest rate of 5%. We've marked that on Figure 7.10.

You'll note that at contributions of $2,000 per year, the return has to be 6% or greater to reach $350,000 in 44 years, but that it reaches $240,000 in 37 years. I've exceeded $240,000 in 24 years. The amazing thing is that the $2,000 per year that I put into my IRA is less than 30% of what I've paid into Social Security to date. So just by earning a reasonable return on my investment (it's been invested only in two no-load mutual funds), I will be able to fund an amount equal to my promised Social Security benefits with only 30% of the Social Security taxes. This makes 70% of my Social Security taxes available to someone else.

From the above data I reach several conclusions:

1. The 65-plus-year-olds don't have a problem; their children do.
2. Using Personal Security Accounts for a part of the taxes can help alleviate the problem.
3. We have a fairly short period of time (the next 10 to 15 years while the assets in the trust fund are building) to implement the PSA. After 15 years the window closes.
4. Politically, it will probably not happen soon enough unless those over 65 push for it.

Folks, our politicians know the numbers. They expect to hear complaints from young workers who know the numbers, but they fear a backlash from retirees who don't know the numbers.

And they know that retirees vote in greater percentages than do younger people. Plus, the problem won't come to fruition for 30 years, which is five to 15 elections away.

So, in order to solve the problems, it is necessary for retirees to insist to their congress people that they reform Social Security for the benefit of their children and grandchildren.