

Globalization, Neoliberalism and the Attack on Social Security

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Abstract

Neoliberal political movements advocate privatization of public pension systems. Globalization imposes pressure on nations to conform to neoliberal policy views with respect to the design and structure of social insurance, including public pension systems.

The paper begins with an investigation of the economic, ethical and ideological dimensions of the privatization debates in the U.S.; it argues that privatization advocates may be largely moved by ideology, since the other reasons advanced appear weak or unfounded. The second part discusses the history of Social Security, the purposes for its creation, and some of its economic effects. Differences between public and private pension systems are considered. A brief international comparison of some aspects of public pension system finance and benefit structures is presented.

The final section considers the ethical, macroeconomic and distributional implications of privatization, prefunding and payroll tax funding, and argues for a pay as you go system financed with income taxes. In order to promote equity, economic security, community, and social cohesion, public pension systems should be universal in coverage. In order to reduce the inequality, income insecurity, and aged poverty generated by market economies, public pension systems ought to be progressive: benefit/contribution ratios should be inversely proportional to income, and progressive income taxes should finance the system. To promote economic growth, the systems should be financed on a pay-as-you-go basis, and should not be prefunded except for an emergency reserve. The fiscal policy recommendations partially depend upon the theory developed by Abba Lerner in the 1940s, and recently advanced by Wynne Godley and Randy Wray: Lerner's "principle of functional finance."

Globalization, Neoliberalism and the Attack on
The U.S. Social Security System

“We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age.” Franklin Delano Roosevelt, August 14, 1935 (statement at the Social Security Act signing ceremony).

“Social Security is social insurance against the general human risk of economic adversity in old age and incapacity to earn a living by employment. Social insurance requires universal participation, in which the premiums of the fortunate pay the claims of the unfortunate.” James Tobin in Aaron and Shoven (1999, pp. 147).

Conservative, neoliberal, pro-capital or pro-business parties in most of the wealthy nations advocate changes in public pension systems, including at least partial privatization of pension systems and reductions in the state-guaranteed levels of benefits; many also advocate increasing reliance upon private, occupational-based pension systems. Both the World Bank (1994) and OECD (1998) have supported these policies; Schwarz and Demircuc-Kent (1999) presents a useful summary and overview of such patterns in pension reform around the world. Within the U.S., the movement to privatize Social Security has become more powerful and popular within the past decade, as

evidenced by the recent Interim Report of the President's Commission to Strengthen Social Security (July 2001).

Arguments in Favor of Privatization

“Privatization” in this context means some combination and degree of (1) accumulating funds in excess of actuarial expected benefit obligations (“prefunding” the system rather than paying as one goes) and assuming that future benefit levels will be constrained by accumulated funds. Defined contribution pension funds offer no guarantees of the benefits the system will pay: benefits are determined by the accumulated contributions and earnings upon retirement. Although prefunding is analytically distinct from the other dimensions of privatization, since it imposes a constraint on future benefit levels it is useful to consider it as an instrumental part of the process; many privatization advocates consider the transition from a guaranteed benefit “pay as you go” system to prefunding as part of the process.¹ (2) Diversification of the asset portfolio of the Social Security Trust Fund into private securities. (3) Establishing individual accounts for some portion of contributions, and allowing individual choice and control over those accounts with respect to portfolio composition and mode of withdrawal. (4) A fourth dimension relates to the degree to which the insurance component of the system is to be retained (insurance against disability, low income upon retirement, and premature death of a wage-earner); “strong privatization” schemes propose at least partial abandonment of social insurance. (Niggle 2000b discusses the degree of privatization in various proposals and presents a spectrum of privacy proposals.) Since strong forms of privatization entail radical revision of the social

insurance system provided by Social Security, they should be seen as an attack upon its integrity and purpose.

The privatization movement derives its impetus and attractiveness from several phenomena, and privacy advocates offer up many reasons for their positions: these reasons may be classified as either predominantly economic or ideological. Two reasons for privatization are discussed in all privatization proposals. (1) The Trust Fund is projected to run deficits in the future, linked to demographic changes, but also to pessimistic assumptions regarding future economic growth, productivity gains, and real wage increases. If these deficits were to obtain, either future taxes and the burden upon future workers must increase or benefits must be reduced. (2) It is assumed that the future rate of return to diversified portfolios that included private equity securities would be higher than the return to contributions (termed “money’s worth”) in the form of expected benefits or to the return on the surplus funds invested in Treasury securities as under the current arrangement. Another factor (3) cited in many privatization proposals is the argument that the national saving rate in the U.S. is too low and that privatization of the Social Security Trust Fund could lead to an increase in saving, investment, and economic growth. These three reasons can be considered “economic” arguments for supporting privatization, given their basis in economic projections or theoretical models of the economy.²

(4) Many financial industry participants and current shareholders anticipate that privatization would lead to an increased flow of funds into private financial markets, resulting in higher profits, commissions, and fees, and an increase in the market value of securities. (Dreyfus 1999 presents an interesting discussion of financial industry support

for privatization; but see Darby and Celarier 1999 for insider skepticism regarding the financial benefits to the industry.) (5) Since privatization would remove the possible necessity to raise future payroll taxes and might even allow such taxes to be reduced, it would reduce the tax burden on business. Finally (6), for many privatization proponents, the transfer of risk and financial burden from the state to individuals is seen as intrinsically desirable as it is consistent with their preferences for a small, weak, noninterventionist state and for increased individual as opposed to collective responsibility. The latter three reasons can be interpreted as primarily ideological and class-based since they clearly reflect the perceived self-interest of the business class and shareholders; they are consistent with the neoliberal view of the world.³ Each of the first three “economic” arguments appears unfounded or at least weak; let us consider them.

Deficits and the Burden on Future Generations

Consider reason (1). It appears unlikely that the projected deficits will actually appear; the system has been running surpluses over the past decade and will continue to do so unless economic growth falls to about half its average over the past century. Baker (2000), Baker and Weisbrot (2000), Eisner (1998), Palley (1998), Papadimitriou and Wray (1999), and Wray (1990-91) present empirical and theoretical evidence that the deficits are unlikely to obtain and that they could be easily financed within the current system if they were to obtain; Niggle (2000b) surveys the literature and makes the same argument. Let us consider the assumptions underlying the projected deficits.

The annual reports of the Trustees of the Social Security Trust Fund present three sets of projections for the outlays, income and resulting budget balances of the systems various funds: a “low cost” optimistic projection, an “intermediate cost” projection and a

“high cost” projection; these alternative scenarios are based upon different sets of assumptions regarding demographics (population growth, age and sex composition, and labor force participation rates) and economics (the growth rates of productivity, real national income, real wages and benefit levels).

The “high cost” scenario is rarely discussed since it appears quite unlikely to obtain; the Trustees Reports describe the “intermediate cost” projections as the most likely scenario, and only occasionally consider the “low cost” projections. Most privatization advocates ignore the “low cost” projections. The Reports also report sensitivity analyses, showing how different assumptions regarding the parameters of the system would affect its budget projections; the most sensitive assumptions are those regarding demographics, and within the economic variables the assumed values for labor productivity growth seems most important, since this is the most important determinant of growth in the tax income of the funds. Productivity growth drives real GDP per capita and real wages; together these powerfully influence the projected levels of tax income and benefit outlays (benefits are indexed to wages).

The intermediate cost assumptions appear fairly pessimistic: in the 2001 Report after about 2010 the population and labor force are projected to grow at only 0.1%, labor productivity growth and real GDP are projected to fall to 1.5%, and real wage growth is assumed to 1.0%. These assumptions then lead to OASDI tax revenues falling below benefits in 2016, but interest on the Trust Fund’s Treasury Securities still allow it to finance the shortfalls in tax revenues until 2025. After 2025 the Trust Fund has to finance its revenue shortfall by redeeming its securities which would be exhausted by 2038. In 2038 the system would be forced to cut benefits, increase income by raising tax

rates or increasing the tax base, borrow funds, or undertake some combination of these changes to the system. The Reports project actuarial deficits of about 1.8% of taxable wage income, or around 1% of GDP over the 75-year period; if taxes aren't increased until 2038 the deficits would be close to 2% of GDP or around 4% of benefits and tax income.

The “low cost” scenario assumptions are a bit more optimistic, and much closer to the historical behavior of the economy. Population and labor force growth assumptions are the same (although Census projects population growth to slow to about 0.5%, the Reports assume 0.1%). But real GDP and productivity growth are assumed to be 1.8%, and real wages to grow 1.4%; these are a bit lower than the average rates for the 20th century (productivity, per capita real GDP and real wages all grew around 2% per year over the past 100 years), but a bit higher than the rates experienced in the 1973-1995 growth slowdown period. The relatively optimistic assumptions of the “low cost” scenario yield budget surpluses for the entire 75-year period, so that the system accumulates about \$15 trillion worth of assets or 533% of estimated benefit outlays for 2075! It seems unlikely that we would allow (or desire) the Social Security Trust Fund to accumulate so many assets – increasing benefit levels or cutting the tax rates would seem to be the more likely response to such an accumulation. But the economic assumptions of the “low cost” scenario certainly seem plausible; to the extent that the actual behavior of the economy resembles this scenario, the less likely is any fiscal crisis for the system.

And even if the projected deficits were to appear, they could be easily offset with relatively small changes in the current tax structure; the forecast actuarial deficit over the 75-year period is about 2% of GDP, about 4% of taxable payrolls; raising payroll taxes

by smaller amounts earlier in the forecast period would also prevent deficits. For example, raising taxes by 1.86% of taxable payrolls now – 0.93% on both workers and employees – would prevent future deficits, according to the 2001 Annual Report of the Board of Trustees (Table II.D.4). OASDI tax rates have been increased about 20 times since the system was created with little political reaction; it seems unlikely that any future deficits couldn't be fairly easily financed with such small tax increases, given the projected heavier demographic (and political) weight of the aged retired.

It is helpful to compare the possible financial burden on future generations with the “real” burden the forecasts imply. Given even the modest increases in productivity assumed by the pessimistic “intermediate cost” forecasts, the real burden of such tax increases on future workers would be relatively small: their real standard of living – their per capita consumption - net of such tax increases would be higher than that of the current generation.

Tom Palley (1998) calculates an “overall dependency ratio” that includes all dependent populations (children, aged and disabled) as a ratio to the active labor force. This ratio peaked in 1950 at 1.42 (each working adult supported 1.42 nonworkers), fell to 1.03 in 1995, and is projected to rise back to 1.08 in 2020 and 1.15 in 2040. Thus, each worker would support about 12% more non-workers than under current conditions, and the dependent population would have a different composition: more retirees, but fewer children. However, labor productivity is also expected to rise, and this should reduce the effective or “real” burden of supporting those dependents. Palley calculates an “effective dependency ratio,” using the pessimistic “intermediate cost” projections for productivity growth (assumed to be 1.3% after 2008 in the 1997 Trustees Report Palley used;

productivity growth is assumed to be 1.5% in the 2001 Report). Palley's adjustment results in an effective dependency ratio of 1.42 in 1950, which fell 0.40 in 1990, and which would continue to fall to 0.33 in 2020 and 0.29 in 2040. Thus the productivity-adjusted "real" burden would be significantly less than current workers bear. And if productivity growth were to be somewhat higher as in the more realistic "low cost" scenario (1.8%), the real burden would be even less. Eisner (1998) presents similar estimates of the dependency burden. Let us consider this important point at somewhat greater length.

Financial and Real Burdens of Dependent Populations

In evaluating the burden on a generation of workers of supporting dependent populations such as the aged and children, it is analytically useful to distinguish real and financial dimensions of the problem. This approach is particularly useful in evaluating the claim that privatization of public pension funds can reduce the future burden of supporting the aged. Operating in the financial dimension of an economy, private and public pension systems (and all such transfer systems) distribute claims to real goods and services; pension benefits or accumulations create claims on consumption for retired recipients while pension contributions or taxes reduce active workers' current consumption; so a pension system can be seen as a financial means of effecting intergenerational transfers of such claims.

For a given a level of real national income, pensioners' exchanging accumulated claims on goods reduces the potential consumption by active workers; but the total pie to be shared is determined by the current level of GDP. If we were to increase the retired folks' claim on goods and services, whether by increasing the money value of their

accumulated portfolios in private or public securities or by simply increasing their current money benefit levels, the effect is the same: it would reduce the share of the national product available for current workers' consumption or investment.

Encouraging or forcing a higher rate of contribution into pension systems, and/or channelling those flows of funds into private markets will not reduce the real burden of support of the aged on future generations unless the funds were to result in a higher rate of investment (Wray 1990-91). There is no evidence that the current privatization proposals would do so, at least not in the U.S.; equity markets in the U.S. do not supply significant net funds to firms to finance capital accumulation. (See Niggle 2000b, Papadimitriou and Wray 1999, Palley 1998, and Wray 1990-91 for extensive discussions of this point.) Analogously, increasing the current tax flows (contributions) into Social Security to increase prefunding held in the form of Treasury securities will not reduce the real burden of supporting the aged in future; it would only establish a set of claims on future goods for the retirees that would have to be satisfied by the future supply of goods.

The nature of the state's problem of financing their support would be qualitatively different under a privatized system (future taxation or borrowing by the OASDI would be less, while the Treasury would have to raise taxes or borrow to meet the Trust Fund obligations), but the real burden on future workers would remain the same. Increasing prefunding of pension systems is not equivalent to survivalists storing up canned foods or squirrels nuts (Bell and Wray 2000, Wray 1990-91). The only way to support the aged at higher levels or to reduce the real burden of a given level of support is by increasing the productivity of labor through time.

The Return on Pension Systems

Consider reason (2). The real (net of overhead and administration cost) returns to stock investments for the next 75 years over which the Social Security Trustees are required to forecast is likely to be only marginally greater than the 3-3.5% real rate the Trust Fund currently earns on its accumulated surpluses held as Treasury securities. Naïve privatization supporters often project the historical average return to stocks of 6-8%; that rate of return assumes all capital gains and dividends are reinvested, and it ignores tax liabilities, overhead administrative costs and the costs of meeting the benefit obligations to current and future beneficiaries.

The assumption of high future returns is partially due to high investor confidence resulting from the long economic expansion of the 1990s, associated high and growing profits during that period, and the high returns to portfolio investments in stocks during the same period, coupled with the awareness that many Social Security participants have experienced and others will experience in future a low rate of return to their contributions with respect to the opportunity cost expected return of investing in private securities. The latter phenomenon is the inevitable result of the maturing of a public pension fund coupled with an aging population (see the discussions in World Bank 1994, Aaron and Shoven 1999, and Diamond 1997, 1999). Given a constant tax rate, benefits proportionate to earnings, a balanced budget and a stable demographic profile, the intergenerational “rate of return” for a mature defined benefit system is constrained by population and productivity growth (Samuelson 1958).

A recent study by Aaron, Blinder, Munnell, and Orszag (2000) estimate real net returns to private individual accounts would be 5.4% over the 75 year period, below the

naïve estimates of 6-8% made by most privatization proponents. The same authors (2001) estimate the effective return to young workers (30 year olds) on accounts “carved out” of current OASDI taxes by allowing 2 percentage points to be contributed to individual accounts; they estimate that net of administrative costs and contributions to maintain current obligations, and adjusted for stock market risk, the returns would be lower than the current Social Security system would offer them. Baker (2000) presents convincing evidence for an estimate of 3.5-4.0%. Even some privatization advocates admit that real net returns to Trust Fund investments are likely to be fairly low (see the discussion of expected returns –averaging 4%- found in both Aaron and Shoven 1999 and in Diamond 1999). If objective observers see little advantage with respect to the rate of return to accumulated Social Security contributions diverted into private securities, what motivates this argument other than rent-seeking by the financial industry and naivete?

Privatization and Savings

Consider reason (3): pro-privatization economists often refer to the necessity to increase the “low” U.S. saving rate, so as to encourage investment. This is a pre-Keynesian macroeconomic view that ignores Kalecki’s and Keynes’s insight that current savings don’t finance or drive investment; rather investment is influenced primarily by profit expectations or “animal spirits”; the rate of investment drives the level of aggregate demand, and aggregate demand determines national production, income and the flow of savings. The availability and price of credit (the interest rate) may influence investment, but not the savings flow; mature capitalist economies are never constrained by insufficient savings. A higher rate of saving might actually lead to a lower rate of economic growth, if it discouraged growth in demand for goods and services, reducing

profitability and the incentive to invest. Finally, even many pro-privatization economists are skeptical that privatization would increase the national savings rate (Aaron and Shoven 1999, Aaron, Blinder, Munnell and Orszag 2001, Diamond 1999). They reason that since the increase in contributions (payroll taxes) envisioned in most privatization proposals are a form of forced savings for workers; this might lead to a decline in voluntary private savings. This argument for privatization also seems weak.

In summation, privatization of Social Security is not necessary, it is unlikely to solve the problems it addresses, and it is likely to have adverse consequences.

- (1) It is not necessary to privatize Social Security to reduce deficits; the deficits are unlikely to occur, and could be easily offset with less drastic changes if they occur. There is not likely to be an increase in the real burden of supporting the aged for future generations.
- (2) The net rate of return to a diversified portfolio managed by the Trust Fund or its successor probably would not be much higher than the historical return to the portfolio of Treasury securities; the net returns to individually managed accounts would be significantly lower than for consolidated Trust Fund managed accounts.
- (3) Portfolio diversification would expose either the Trust Fund or individual contributors to market risk.
- (4) In either case inequality of benefit income would increase, either across cohorts if the Trust Fund were to manage the portfolios or across both cohorts and individuals if the accounts were individually controlled and managed. Aged poverty might increase if market returns were low or negative.

- (5) If privatization did lead to an increase in the national saving rate, it might very well depress economic growth.
- (6) The likely increase in inequality and the decoupling of benefit levels to contributions as they become determined by market forces is likely to lead to a reduction in political support for the system, especially for the essential social insurance (social safety net) features.
- (7) The increase in inequality is likely to reinforce individualistic ethics and values at the expense of social, collective, and communal values. This may be an unstable reinforcing process as James Galbraith (1998) argues; beyond a threshold level, inequality encourages political values and processes that increase inequality.

Ideological Arguments in Favor of Privatization

“Globalization” refers to a set of interactive and reinforcing processes: the increasing international integration of markets for goods, services, assets, labor and capital; the rise of transnational private and public institutions; and the creation of a world-culture based upon industrialization, electronic communications, and commoditization. Another term for the process is mature, global capitalism. For some observers, the globalization process appears to have accelerated within recent decades, resulting in a qualitatively different global system of political economy. From this perspective, the new global economy is characterized by a reduction in the power of individual nation states and even a loss of sovereignty, and a reduction in the power of individuals as well, while financial capital and supranational institutions have gained power. (Cohen 1998 provides a review of the globalization literature; see also Henwood 1999, 2000 and Greider 1997.)

Neoliberalism is a world-view, ideology, and political stance that encourages and supports globalization; it is a restatement of classical liberalism, in which humans are seen as inherently self-seeking, materialistic, and competitive. Society is seen as the collectivity of those atomistic, self-seeking individuals, competing for survival, power, wealth, and prestige. From this perspective, a desirable social order requires a set of institutions which encourage, protect, and nurture competitive behavior, since the result of the competitive interaction is an increase in wealth and happiness (“the greatest good for the greatest many”). Within the domain of political economy, economic policies which define and protect property rights are seen as essential, since doing so reinforces the pecuniary incentive system, which encourages an increase in wealth as the result of hard work, saving, and investment in financial, physical and human capital. The adverse effects of increased inequality are mitigated by increased wealth: the poor get relatively smaller but absolutely larger pieces of a larger pie. This is a familiar story.

Neoliberalism, especially in its “new classical economics” guise that includes monetarism, rational expectations, public choice, and real business cycle theory, supports globalization by rationalizing and arguing for free markets and against government intervention in markets, in production-labor processes, or in consumption choices. Where hegemonic, this economic philosophy reduces the power of nonmarket institutional constraints such as those imposed by the state to control, influence, or shape economic processes including the accumulation of capital (and concomitant social power), the flow of funds, the pricing of assets, consumption patterns, or the location of production. Unconstrained international competition, increasing returns to scale and scope, and the increasing concentration of market power then effectively destroy small

local producers, transform consumption patterns in smaller countries, and transform cultures as well. Most often the effects include increases in inequality in the distribution of income, wealth, and power, and a degradation of the quality of life, especially for those without the wealth and power to protect themselves (consider Mexico in the 1990s). This is also a familiar story.

Neoliberalism and globalization affect the larger wealthy nations as well. International competition for profit, power, and markets leads to fierce pressure to hold down costs of production. Since most public pension systems are financed by taxes on wages, these systems increase the cost of labor for employers; firms operating in nations with expensive public pension systems are at a competitive disadvantage with respect to firms operating in nations with less generous pension systems.

Given the logic of capitalism, absent state intervention, wages in wealthy nations should stagnate, rise more slowly, or even fall, while perhaps rising (eventually, possibly?) in poorer nations once their “reserve armies of labor” are all employed in the money economy. Empirically, inequality in wage and income distribution increases both within and across the poor and wealthy nations, although redistributive institutions and policies mitigate the effects in social democratic corporatist societies. (See Ervik 1998, Galbraith 1998, Gottschalk and Joyce 1997, Gottschalk and Smeeding 1997, and Korpi and Palme 1998 for discussions and analysis of changes in income and wage distributions, and of the distributional effects of institutions.)

The ultimate, deep, decisive force driving the privatization movement may be the conjuncture of globalization and neoliberal ideology, especially among conservative intellectuals, the business class, and their representatives in government. Such

privatization proponents may support privatization primarily because of their preferences for institutions that encourage private assumption of risk and responsibility and reduce collective risk-taking and responsibility on the part of the state, and because of their preference for reducing the relative size and influence of the state within the economy and the larger society. Probably they see such institutions and changes as advancing their perceived self-interest as well as that of the commonwealth (consider reasons 4 and 5 above).

This perspective is in clear opposition to the values inherent in collective, communitarian, liberal and socialist philosophies, which see the state as rightfully and necessarily undertaking to provide for our collective security. Social insurance systems historically have been devised to reduce economic insecurity, to reduce the individual consequences of economic adversity by collectively assuming and sharing risk. They were not intended to serve as an individual means of accumulating financial assets. Public pension rights have one of the key characteristics of financial assets in that they represent a claim on a flow of income payments with a present value that may be estimated; but since they are not transferable in secondary markets and hence illiquid they are different in most other respects.

Social Insurance in the U.S

The creation of the U.S. Social Security system was originally a response to two Great Depression problems: the funding crisis of state and local poor relief and aged relief systems, and the chronic and severe poverty of the elderly, both exacerbated by the depression. A growing awareness that capitalism, industrialization, and urbanization had destroyed or transformed extended families and community ties and reduced the ability of

families and local communities to support the elderly, disabled and other deserving poor provided a sympathetic context for a national public policy response. Also important in shaping the response was the success of earlier European social insurance systems, most notably Germany's.

“Security was attained in the earlier days through the interdependence of members of families upon each other and of the families within a small community upon each other. The complexities of great communities and of organized industry make less real these simple means of security. Therefore, we are compelled to employ the active interest of the Nation as a whole through government in order to encourage a greater security for each individual who composes it...This seeking for a greater measure of welfare and happiness does not indicate a change in values. It is rather a return to values lost in the course of our economic development and expansion.” F.D. Roosevelt, “Message of the President to Congress, June 8, 1934.”⁴

The Old Age Survivors and Disability Insurance (OASDI) system began as a limited program that provided small pensions to retired workers over age 65; it also provided funds to support state welfare programs for the aged. The pensions were to be funded by a payroll tax accumulated in a Trust Fund (beginning in 1937) dedicated to the pension benefits; the level of individual monthly benefits were pegged to the workers' wages and contributions (monthly pensions were first paid in 1940; lump sum payments were made beginning in 1937).

The program was part of the New Deal's comprehensive Economic Security Program, which also put in place a system of unemployment insurance and aid to families with dependent children. By 1939, amendments to the original act provided payments to the spouse and minor children of retired and deceased workers; in the 1950s, cost of living adjustments were first made; in 1954 a disability insurance program was added; in 1965 Medicare providing health insurance for the aged was established; and in the 1970s automatic cost of living adjustments were provided.

Gradually the U.S. established a national system of social insurance for workers and their families against the risk of being old and poor, unemployed or disabled; eventually it provided health insurance for the aged, and benefit levels increased in generosity over time. Social Security became the single most important public program reducing the inequality and poverty that result from market forces. Over two-thirds of the elderly receive 50% or more of their income from Social Security; 30% of the elderly rely upon Social Security for at least 90% of their income. While the poverty rate for people over 65 (9.7% in 1999) is a bit lower than the rate for the general population (11.8% in 1999), without Social Security about 50% of the aged would be officially poor. The various Social Security programs reduce the overall U.S. poverty rate about 6% (estimates found in Eisner 1998, and Aaron in Aaron and Shoven 1999).

Although the Social Security tax system is regressive (a proportional tax on labor income with no exemption except for wages above a cap; no taxes on other forms of income), because the benefit system is very progressive - benefits replace more than half the income of low income workers, about 40% for the average worker, but only about

20% for high income workers - the overall effect on lifetime income is inequality reducing.⁵

In spite of its powerful antipoverty and redistributive effects, Social Security enjoys strong and widespread political support across all social classes and within the electorate, which tends to be older and more affluent than the general population. This is partially because of its efficiency and success in providing desirable services, but also perhaps because it is not widely perceived as an egalitarian and anti-poverty program: there are no means tests for Social Security and benefits are perceived as tied to individual contributions. Privatization proposals could possibly weaken that support. The construction of a two-tier system which guaranteed a base benefit or “safety net” and established a defined-contribution tier in which benefits would be determined by individual portfolio choices and market returns would be likely to result in much greater inequality in benefits both across and within age cohorts (see the discussions in Aaron and Shoven 1999, Baker 2000, Eisner 1998, Diamond 1999, Niggle 2000b and Papadimitriou and Wray 1999). Reducing inclusivity and sharply differentiating returns to individual beneficiaries’ contributions would be likely to reduce solidarity and political support for the safety net features, especially among the affluent. Features that reduced the clear linkages between contributions and benefits might reduce the support of the broad middle classes.⁶ It is important to understand that the pension fund element of the Social Security system is an essential element of our social insurance system; it is not an investment scheme or vehicle.

Public and Private Occupational Pension Systems

The original and primary purpose of public pension systems in most countries is to provide insurance against loss of income in old age; universal coverage spreads the risk and enlarges the financial base (taxes or contributions). Historically, most countries have increased the generosity of benefits and broadened coverage along with rising real incomes. The public pension systems are a powerful factor in reducing poverty, inequality, and income insecurity for the aged.

Private pension systems are occupational-based: coverage is a function of employment in particular industries and/or firms that offer such systems (although coverage is universal in a few countries). Benefits are generally tied to contributions by participants and employers, and usually related to the level of earnings. The employers' contributions are a form of deferred wages; the employees' contributions a form of saving or deferred consumption. There is a very wide range of participation, coverage, replacement rates (the ratio of benefit income to earnings), and security for private pension funds across countries.⁷ Because the benefits are tied to participation and contributions, the distribution of benefits closely reflects the distribution of earnings (wages). The U.S., which has the highest degree of earnings and income inequality among the wealthy nations (Gottschalk and Smeeding 1997), has the highest degree of inequality in private pension benefit distribution; it also has the highest degree of inequality in aged income distribution and the highest rate of aged poverty. There is a high correlation across countries with respect to income inequality, earnings inequality, aged poverty, and private pension inequality (Behrendt 1999).

In most countries, private pension systems enhance rather than reduce inequality, with the important exceptions of countries such as Norway, Sweden and Finland, in

which widespread or universal participation and generous benefits are mandated by public policy. (The U.K. private pension system also greatly reduces poverty without requiring participation, but the distribution of private pensions is very unequal – aged poverty is reduced but inequality is still quite high in the U.K.)

Private pension systems are not likely to be as effective as public pensions in reducing aged poverty, inequality, and income insecurity – unless a country is willing to define parameters of the system in order to do so (including universal participation for all employers and employees, generous minimum benefits, safeguards against market risk, and complementarity with public systems, such as fixing the minimum public benefit at a high level). Unless the proper constraints and incentives are established, private systems must be understood as supplements rather than substitutes for public systems, allowing some fortunate individuals the opportunity to accumulate individual economic assets in addition to the benefits universally provided (currently 35% of U.S. pensioner households receive private pensions, Behrendt). In a country like the U.S., which has one of the least generous public pension systems, with a replacement rate ranking tenth among the wealthiest eleven OECD countries (Gruber and Wise 1997), increasing reliance on private pensions rather than the public pension system would be likely to have adverse effects on aged poverty, income insecurity, and income inequality, especially if the public pension system were reduced in coverage or generosity.

An Alternative Proposal for Social Security

Although the Social Security system is unlikely to face a financial crisis in future, it does have several serious problems and shortcomings: (1) poverty and inequality are high among the elderly: minimum benefit levels are inadequate; (2) the tax system is

regressive; and (3) the OASDI fiscal system potentially depresses aggregate demand and growth. I propose a set of changes that would retain the core characteristics of the current system while improving its performance from the perspectives of both equity and macroeconomic performance. Those core characteristics are a universal defined-benefit system that provides disproportionate benefits to low income earners without an income or means test, that insulates the participants from many forms of risk, and that pays benefits in the form of an annuity.

Consider point (1). Although Social Security reduces poverty, poverty is still higher in the U.S. than in other wealthy countries. The official aged poverty rate in the U.S. is about the same as the rate for the general population (9.7% and 11.8% respectively in 1999, for example); but using the widely accepted OECD poverty line of one-half of adjusted median income, the U.S. aged poverty rate is about twice that level: 24.2% in 1996. The U.S. elderly poverty rate is about twice the rates in other wealthy countries except Australia (Behrendt 1999). Aged single women and widows are disproportionately poor in the U.S. (2 out of the 2.3 million elderly poor living alone in 1992 were women). Since their average lifetime wage income is significantly lower than men's their Social Security benefits are lower (about $\frac{3}{4}$ the male rate for single women: \$611 vs. \$819 monthly in 1997). Women are much less likely to have adequate private pensions (for example, in 1994 13% of women received private pensions averaging \$2,682 compared to 33% of older men whose pensions averaged \$7831).⁸ More generous minimum benefit levels could be used to reduce elderly poverty; I propose setting the minimum PIA (Primary Insurance Amount) at the poverty levels (\$7818 for singles over 65, \$9862 for an elderly couple in 1998). The projected future surpluses

certainly allow us to finance benefit increases for the elderly poor (surpluses are projected until at least 2024, even under the pessimistic forecasts); and enhanced benefits would reduce those surpluses to good effect as discussed below.⁹

Aged poverty is caused by the same factors that contribute to the inequality in income distribution: the distribution of resources, market forces, and the effects of taxes and transfer systems. With regard to point (2), the regressivity of the OASDI payroll tax system is an important contributor to both inequality and poverty for the working poor. Regressivity of the OASDI could be reduced within the current tax system by exempting low incomes or refunding taxes on low incomes, and by removing the cap on high wage income. But a more straightforward solution would be to replace the payroll tax with the Federal income tax which falls on a broader income measure; Eisner (1998) estimates that increasing income tax rates 8 percentage points within each bracket would raise as much revenue as the 12.4% payroll taxes.

Consider point (3). The current system discourages employment, investment, and productivity growth. By raising the cost of labor, it discourages employment. The payroll tax burden on low- and mid-wage workers is high (low-wage workers pay no Federal income taxes; the OASDI taxes are a greater burden than income taxes for mid-wage workers), reducing their ability to support themselves and their family and to accumulate assets. This then reduces aggregate demand and depresses investment and future productivity growth.

Keynes wrote (1936, pp.372) “The outstanding faults of the society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of income and wealth.” He proposed practical policy measures to reduce

excessive inequality and offset the tendency toward recession. These are familiar to us: low long term interest rates coupled with high levels of public investment; he appears also to have advocated a form of industrial policy as well (Crotty 1998). Keynes reasoned that his full employment policy would reduce inequality (more workers employed at higher wages, lower returns to capital due to lower interest rates and a higher rate of investment).

Abba Lerner (1943) focused on the fiscal policy aspects of Keynes's insight; in the 1940s and 1950s he argued that the first priority in setting budget levels ought to be consistency with the level of aggregate demand necessary for full employment and price stability (he was particularly concerned with preventing price deflations, as was Keynes). His views became widely accepted among post WWII economists as the "theory of functional finance," appearing in the fiscal policy chapters in most textbooks published in the 1960s and 1970s. Recently some contemporary economists have reminded us of the importance of this neglected insight (Godley 1999 and Wray 1998).

From this perspective, the projected future Social Security surpluses threaten future investment and growth by reducing the level and growth rate in aggregate demand, which constrains national output and income. If the government's high employment budget is in surplus, and if that surplus is not offset by either a private sector deficit or a current account trade surplus, aggregate demand will be depressed and the economy will operate below high employment, as in Lerner's theory of "functional finance." Another effect of government surpluses is that they destroy money; without offsetting central bank operations, government budget surpluses reduce bank reserves, which tends to raise interest rates and further depress demand for output.¹⁰ Depressed aggregate demand and

excess capacity in industry will reduce the incentive for firms to invest; depressed demand reduces profits, constraining firms' ability to finance investment. Further, since the economy will not attain high employment, tax revenues are likely to be below projected levels and the forecast surpluses may be replaced by actual deficits.

Godley (1999) argues persuasively from the basis of Lerner's theory that the recent U.S. budget surpluses resulting from the Social Security budget have so far been offset by the ability and willingness of the household sector to run deficits. In the late 1990s, household sector deficits (financed by borrowing) of about 5% of GDP have matched the demand depressing effects of both the trade deficit and government surplus, which together have also been about 5% of GDP. But it seems unlikely that the household sector can continue to run such deficits indefinitely, since that behavior implies a rising debt/income and perhaps debt/asset ratio for the households, which lenders should eventually interpret as requiring a reduction in credit availability.

If we accept the validity of this Keynes-Lerner analysis, we are led to the conclusion that it would be better to begin to reduce the relative size of those state surpluses, which could be accomplished by phasing in a replacement of the OASDI system with partially offsetting income tax increases attempting to reduce the projected size of the high employment structural deficit. In future, the Social Security system should be returned to its original PAYGO basis. Another complementary strategy would be to increase state spending on useful public investment, which not only creates short run demand and employment, but also enhances future productivity.

This approach to the macroeconomic problems of the current Social Security system could be coupled with a set of modest policy changes to encourage voluntary

saving and asset accumulation by the poor and middle classes. Eisner (1998) proposes a set of voluntary tax exempt personal savings accounts administered by the Social Security Trust Fund. The accounts would be similar to private IRA, 401K, and Keogh plans, except administered by the Trust Fund. Investment would be limited to broad index funds ranging from Treasury securities across equities. All withdrawals would be in the form of annuities, and early withdrawals would be forbidden. Overhead and administrative costs would be minimized by economies of scale and lower marketing costs as compared to private funds.¹¹

Such a reconfigured Social Security system would continue to meet its primary responsibility of social insurance against the risk of losing income because of being unable to support oneself due to disability or old age, but do so more in a more equitable and generous fashion. Its financial system would no longer discourage economic growth. And it would remain an integral part of our community's mutual commitment to each other within and across generations, only stronger.

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¹ The U.S. Social Security System was on a pay as you go basis until 1983, when Congress adopted the recommendations of the Greenspan Committee to increase tax rates so as to accumulate reserves in a Trust Fund.

² The Interim Report of the President's Commission to Strengthen Social Security (2001) advances all three of these arguments; it emphasizes the importance of demographic projections of higher ratios of retirees to workers and the subsequent greater burden on future workers in necessitating reforms.

³ For explicit statements of this ideological preference, see the discussions in Aaron and Shoven 1999, Diamond 1998 and 1999. The Draft Report of the President's Commission to Strengthen Social Security is also explicit regarding the Commissioners' preference for more reliance upon individual provision for retirement. The Cato Institute's privatization proposals offer similar clear statements of ideological preferences; for example, see the articles found in links to their home page on privatization, "The Cato Project on Privatization", <http://www.cato.org/pubs/briefs/bp-038.html>

⁴ The Social Security System home page provides an excellent introduction to the history of the U.S. Social Security System, quotes from involved parties such as this statement by FDR to the Congress and also his statement found in the epigraph for this paper, which he made at the Social Security Act signing ceremony. The home page also has links to other useful information. The history documents are found at <http://www.ssa.gov/history.html>.

⁵ To the extent that high wage workers outlive their poor contemporaries, the redistribution effects on lifetime income is reduced (World Bank 1994, pp 11, 133-135). Mean individual benefits were about \$8500 in 1997 (about \$10,000 for a family receiving Social Security); the "average wage index" for that year was \$27,400. The "average wage index" is the average annual lifetime earnings at current dollars in the retirement year; it is higher than the mean or median current wage for any given year. Data from the 1998 Annual Report of the Trustees of the Social Security System, P. 4. Another estimate for replacement ratios using different income concepts calculated by Koltz (1997) shows the average worker receiving 44% of average earnings, while low- and high- income workers received 80 and 25 percent, respectively.

⁶ Walter Korpi and Joakim Palme (1998) present cross-country empirical evidence supporting the hypothesis that the most effective programs in reducing poverty and inequality are those which are most inclusive ("universal") and neither targeted at the poor nor means tested. Broad political support for universal programs allows them to be relatively generous and so reduce poverty and inequality, even though they may be inefficient from the economists' narrow perspective (poverty is reduced less for a dollar spent in a universal program such as a public pension system than for a dollar spent in a targeted program such as food stamps). The World Bank (1994) also argues that inclusivity is correlated with strong and broad political support for social insurance programs. Korpi and Palme favor programs that clearly link benefit levels and eligibility to contributions, and which are broadly construed as advancing the interests of the middle class taxpayer.

⁷ Behrendt (1999) provides an excellent introduction to the variety and effects of private pension funds across some of the wealthy OECD countries as well as a valuable bibliography. This section relies heavily upon that source. World Bank (1994) and Gruber and Wise (1997) provide cross-country comparisons of the features of public pension systems such as replacement rates, retirement age, tax systems and rates, and pension system trust fund portfolios. The U.S. system is among the least generous in most respects (including the percentage of earnings replaced by benefits and retirement age), and its tax system among the most regressive.

⁸ The Century Foundation provides useful data regarding Social Security and links to helpful sources; this data regarding the situation of elderly women is presented on their website along with sources. http://infor@tcf.org/Publication/Basics/Social_Security/Whats_Right-2.html

⁹ The cost of raising the minimum PIA to the poverty levels will be estimated and reported in a future paper.

¹⁰ The insight that without offsetting central bank operations surpluses reduce bank reserves and "money" is identified with the "Chartalist" school; see the exposition in Wray 1998. For comment and criticism of the Chartalist view see Niggle 2000a.

¹¹ The World Bank (1994, pp. 135-37) presents a set of characteristics of public pension systems designed to reduce inequality and poverty which are quite similar to those in this proposal (pp. 135-37). The books by Diamond (1999) and Aaron and Shoven (1999) both present useful discussions and estimates of the costs of private accounts. Diamond 1998 provides a clear discussion of the relatively high costs of transition toward a defined-contribution pension system and the high costs of individually managed private accounts.