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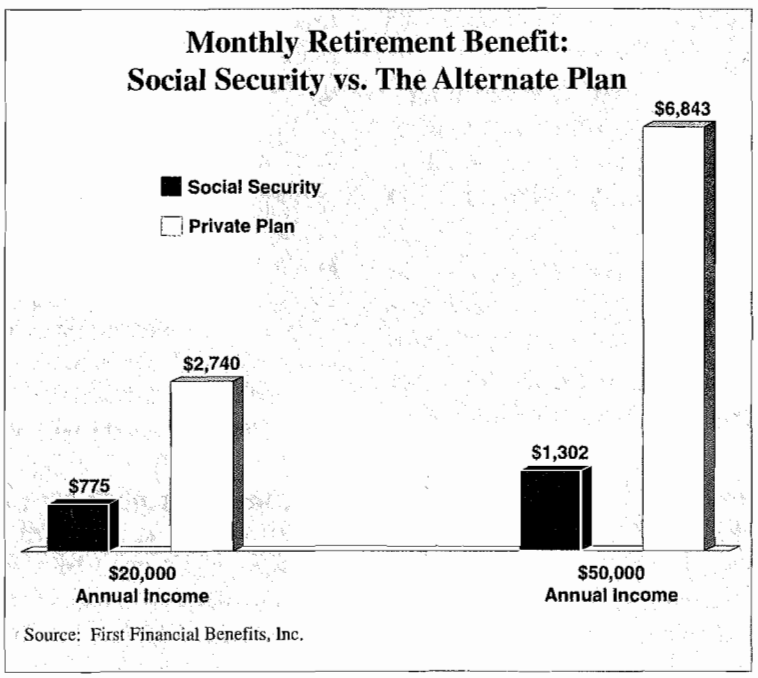
Some Americans Already Have Privatized Social Security

From the inception of Social Security in 1935, its proponents have encouraged Americans to think of it as a type of private pension plan. Now most people realize that the Social Security Trust Funds are trust funds in name only and consist of nothing more than IOUs the government owes to itself. Various polls show most Americans are skeptical that Social Security will be there when they retire.

However, employees of three Texas counties that opted out of the Social Security program more than a decade ago are earning an average 6.5 percent interest, compounded daily, on their vested personal retirement accounts.

Can a privatized Social Security system work? It already does. Let's see how.



How the Social Security System Works. Currently, employers and employees each pay 6.2 percent (a total of 12.4 percent) of an employee's income into the Old Age, Survivors and Disability (OASDI) program for retirement benefits. This does not include the 1.45 percent payroll tax employers and employees each pay to fund Medicare's Hospital Insurance program.

In general, individuals must contribute for a minimum of 40 quarters (10 years) to receive Social Security retirement benefits, or 20 quarters to receive disability benefits. In return for these contributions, individuals generally can expect:

- A monthly check after retirement, with the average check being $697 in December 1994.
- A monthly check for a qualified disability until the recipient returns to work or reaches retirement age.

In addition, a surviving spouse receives a monthly benefit equal to 100 percent of the deceased spouse's basic benefit and surviving children under the age of 18 each receive an amount equal to three-fourths of the deceased parent's benefit.

Social Security's Financial Crisis. Social Security is a pay-as-you-go system under which taxes collected from current workers are used to pay current retirees. That was sustainable in the past. For example, in 1950 there were 16 workers providing benefits for each retiree. However, today the ratio has dropped to 3.3 workers for each retiree, and by the year 2030 the ratio will be less than 2 to 1.

The demographic changes and the program's expansion have driven the Social Security tax rate up from 2 percent (1 percent each from employer and employee) initially to 12.4 percent today, and the maximum wage subject to taxation has risen from $3,000 to $62,700. As a result, the ratio of benefits to taxes for today's workers has dropped significantly. The Social Security Administration estimates that those born in 1877 (and retiring in 1942) got an average of 36.5 percent real rate of return on their Social Security contributions, while those born in 1950 will receive on average just a 2.2 percent return, and those born in 1975 will get a 1.8 percent return. Future workers will get an even worse deal.

Everyone recognizes that this trend is unsustainable. According to the latest report from the Board of Trustees of the Social Security Trust Funds:

- Social Security tax revenues will be insufficient to pay current benefits as early as the year 2012.
- By the year 2029, Social Security outlays will have completely exhausted the trust funds, and current revenues will fall short of expenditures by about 2 percent of gross domestic product (GDP) annually.

Dallas Headquarters: 12655 N. Central Expy., Suite 720 • Dallas, TX 75243-1739 • 214-386-6272 • Fax: 214-386-0924 • E-Mail: ncpa@onramp.net
Washington Office: 727 15th St. N.W., 5th Floor • Washington DC 20005 • 202-628-6671 • Fax 202-628-6474

For more information: Curt Erickson in Dallas at 972/386-6272 or Joan Kirby in Washington at 202/628-6671

- In order to make the payments without cutting benefits, the Trustees estimate that payroll taxes will have to rise from the current 12.4 percent to 18.8 percent.

A Private Retirement Plan That Works. The initial Social Security Act permitted municipal governments to opt out of the system — a loophole that Congress closed in 1983. In 1981, employees of Galveston County, Texas, chose by a vote of 78 percent to 22 percent to leave Social Security for a private alternative. Brazoria and Matagorda counties soon followed, swelling the private plan to more than 5,000 participants today. In the private plan, contributions are similar to those for Social Security but returns are quite different.

- Initially, employees and their employer were each required to contribute 6.13 percent of income; recently, the counties increased their contribution to 7.65 percent — for a total contribution of 13.78 percent.
- Of that 13.78 percent, 9.737 percent goes to the employee's individual retirement account, which pays a 6.5 percent average interest rate, compounded daily.
- The remainder pays for disability and life insurance premiums to cover the employee in case of an accident or death.
- Workers continue to pay their Medicare payroll taxes and to receive Medicare benefits upon retirement.

But while the cost of the private program, known as the Alternate Plan, is virtually the same to the employee and employer as Social Security, the benefits are far greater. According to First Financial Benefits, Inc., which created and administers the plans:

- A person retiring today at age 65 with 40 years of deposits and an annual salary of $20,000 would retire with $383,032 in a personal account.
- Someone with a $30,000 salary for 40 years would retire with $573,782.
- And a person with a $50,000 salary for 40 years would retire with $956,303.

A personal retirement account this size provides a much larger postretirement income than does Social Security. Moreover, retirees under the Alternate Plan have a number of options not available to retirees under Social Security. For example, those with the Alternate Plan can choose among several annuities or take their money in a lump sum. As the figure shows, under one option:

- A retired $20,000-per-year worker with the personal retirement account would receive $2,740 each month at current interest rates, while Social Security benefits would be about $775 per month.
- A $50,000 per year worker would receive $6,843 from the private plan, compared to $1,302 from Social Security.

In addition, the employer's contribution pays for much more generous benefits than those provided by Social Security.

- The life insurance benefit is three times the worker's salary (with a minimum benefit of $50,000 and a maximum of $150,000); Social Security, by contrast, pays a one-time death benefit of $255 to a surviving spouse.
- Disability insurance under the Alternate Plan pays 60 percent of an individual's salary until age 65 or until the individual returns to work and is relatively easy to qualify for, while Social Security disability benefits can be very difficult to qualify for and are unavailable to young workers who have not yet worked the required amount of time.

Is the Program Safe? One of the biggest challenges to privatizing Social Security is to ensure the safety of the contributors' investments. Workers under the Alternate Plan are required to make their payroll contributions, and the money is invested in annuities with a highly rated insurance company. Though the interest rate can fluctuate from year to year, the financial institution that invests the money must pay a guaranteed interest rate for that year.

Conclusion. Employees of three Texas counties are enjoying rapid growth in their retirement incomes, better benefits than those offered by Social Security and the satisfaction of knowing that the money deposited in their accounts belongs to them and will be there when they retire. Privatizing Social Security is not a distant dream; for some Americans it is a present reality. Fairness and true *social security* demand that all Americans have the same opportunity.

This Brief Analysis was prepared by NCPA Vice President of Domestic Policy Merrill Matthews Jr.