# Allowing Opt Out from Social Security Doesn't Make Sense

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**MarketWatch Blog** by Alicia H. Munnell

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One could have hoped that the nation could come through this electoral season with only a nod to the desire to fix Social Security's modest financing shortfall as quickly as possible.  Alas, that is not to be!  Instead, Governor Perry and others have big plans for fundamentally changing the nation's primary retirement program.  The Governor points to the plan adopted in Galveston and two other Texas counties as a model.  These plans guarantee a base level of interest on retirement contributions and allow employees some additional returns when the market goes up.   The problem with the Galveston-type approach is that Social Security's "legacy costs" – costs associated with paying benefits in excess of contributions to early generations of retirees – increase for those workers who remain in the system.

The 1935 Social Security Act set up a plan that bore a much stronger resemblance to a private insurance plan than to the system we know today. The legislation called for the accumulation of a trust fund and stressed the principal of a fair return.  The 1939 amendments, however, fundamentally changed the nature of the program.  They tied benefits to average earnings over a minimum period of coverage, and thus broke the link between

lifetime contributions and benefits.  As a result, early cohorts received windfall returns on their contributions.

The story of Ida May Fuller is an extreme example.  Ms. Fuller had worked under Social Security for less than three years when she became the first person to claim monthly benefits.  She died at the age of 100, after receiving benefits for 35 years.  She clearly enjoyed an extraordinary rate of return on her contributions to the system.

Virtually all observers agree that the decision to provide full benefits to early cohorts was a wise one.  Many of these people had fought in World War I and had endured the economic devastation of the Great Depression. Poverty rates among older people were at unacceptably high levels. Moreover, the recession of 1937 followed rapidly after the introduction of the Social Security system, making the accumulation of a substantial surplus undesirable on fiscal policy grounds.

The benefits paid to the early retirees did not come for free, however.  If earlier cohorts had received only the benefits that could have been financed by their contributions plus interest, trust fund assets would be much larger than they are today.  The assets in that larger fund would earn interest and that interest would cover a substantial part of the cost of benefits for today's workers.  Without it, payroll taxes must be substantially higher.

To see the impact of having, in essence, given away the trust fund, compare the cost of a funded and a pay-as-you-go system.  Assuming the Social Security Trustees' real interest rate of 2.9 percent, the average worker and his employer would have to contribute about 9 percent – 4.5 percent each – to generate a benefit equal to 36 percent of earnings (the projected Social Security replacement rate for the average earner at age 65 once the full

retirement age equals 67). Giving away the trust fund to early generations of retirees moved the system to a largely pay-as-you-go system. With a projected ratio of two workers for each retiree, a 36-percent replacement rate would require, in a world of no wage growth, a contribution rate of 18 percent – 9 percent each for employer and employee. That is, each of the two workers (and their employers) would pay for half of the retiree's 36 percent benefit. Add in wage growth, and the cost rate falls, but remains well above that in a funded system.

So the reason that projected payroll tax rates are high is that the system paid benefits to early cohorts and has not built up a trust fund. The long-run cost of the program incorporates the legacy costs associated with the absence of such a trust fund. These facts have two implications. First, any jurisdiction opting out escapes paying its fair share of the legacy costs and shifts the burden to those who remain in the program. Second, cost comparisons between Social Security and entities that opt out are not meaningful because those who opt out have an unfair advantage by escaping their fair share of the legacy costs.