Galveston vs. Social Security

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MarketWatch Blog by Alicia H. Munnell

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It's important to get the Galveston story straight, so it can be put to rest.

Most importantly, comparing Social Security to Galveston is comparing apples to oranges. Social Security payroll tax rates cover not only the cost of current benefits but also the program's legacy costs. The legacy costs exist because benefits were paid to early retirees in excess of their contributions as discussed in last week's blog post.   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. Roughly 3 percentage points of the current 12.4 percent payroll tax go towards covering the startup costs.

Galveston is not saddled with these legacy costs, so that it should be able to provide more than Social Security with a given level of contribution. But the Galveston model is not replicable on a national basis; the costs associated with the start-up of Social Security have to be paid by someone. If the Social Security system were closed down today, revenue would have to be raised from some source to cover the benefit commitments made to date. Therefore, Galveston cannot serve as a model for any national reform.

That said, what's going on in Galveston? The story began in 1981 when the County of Galveston opted out and set up an alternative plan in place of Social Security. Two other counties – Matagorda and Brazoria – also opted out at the same time and set up similar systems.

Under the system, the employee contributes 6.1 percent and the employer 7.8 percent of pre-tax payrolls. Slightly less than half of the employer's contribution goes to retirement and the remainder to pay for life and disability insurance benefits. Retirement funds are pooled and put out for bid. The institutions guarantee a base level of interest and allow employees some additional returns when the market goes up.

The last comprehensive assessments of the Galveston plan date from 1999 (U.S. Government Accountability Office and the U.S. Social Security Administration). Those studies confirm numbers in editorials showing that the *initial* benefits for middle- and upper-income employees are higher under the Galveston plan than under Social Security. But that is the beginning not the end of the story.

- The benefit structure is not progressive, so low income workers receive less.
- Dependents benefits are not automatic, so married couples can do worse.
- Benefits are not indexed for inflation, so their value declines over time.

We need a national program like Social Security to provide a base of retirement income. All jurisdictions should participate in Social Security to share the legacy costs associated with the startup of the program. Galveston is getting off scot free. Moreover, data on *initial* benefits for middle- and upper-income *individuals* substantially overstate the program's success.