Objective of Social Security

The objective of social security is to provide a retirement income for every worker and worker's spouse. Upon reaching retirement age, one receives a government pension.

To the founders of social security in the 1930's, it was important that the recipient of the pension should see it as an earned entitlement, not just a welfare grant from the government.

Social Security Tax—A Flat Tax

For an employee, the social security tax is proportional to wages and salary. There are no deductions, and the tax is withheld from the paycheck. The employer pays an equal amount on behalf of the worker. Because there are no deductions and the tax rate is high, the total tax collected is enormous.

There is no social security tax on other types of income—interest, dividends, capital gains, rent, pensions, etc.

There exists a maximum income subject to the proportional tax. If an individual has a higher wage and salary income, he pays the social security tax on the maximum income only, and pays no tax on additional wages and salary. (The employer must pay the tax on the entire wages and salary.)

Social Security Benefits—Progressive

Social security benefits are *progressive*: benefits are not simply proportional to the social security tax paid during one's lifetime; instead, a doubling of the tax raises the expected benefit, but by much less than double.

Transfers Between Workers

Because benefits are progressive, social security involves a transfer of wealth between workers.

For an employee who retires after a full career, the retirement benefit is small relative to the tax paid, so the difference is a transfer to others. If the social security tax had been invested in a pension fund owned by the worker, the retirement benefit would perhaps be five times as high. The tax paid is so great that one would expect a retirement income *higher* than one's income while working. From this point of view, social security tax is primarily a tax on the worker, and only partially a pension plan.

Transfers from Workers to Others

Social security is also a net tax on workers. In recent years the social security taxes collected have significantly exceeded the social security benefits paid. The difference finances general government spending.

Our late New York Senator Moynihan persistently complained that this situation was unfair to workers. Why should workers pay a special tax not levied on others to finance general government spending?

Privatization

Some propose that social security should be *privatized*. The tax collected from each worker would be invested in a pension fund owned by the worker, and the worker's pension would depend on whether the return on the fund was good or bad. (Typically the pension for a university professor works this way.)

Loss of Security

Under privatization, the word "security" would no longer apply. A worker with low wages and salary and a short career would receive only a tiny pension. For an unlucky worker, his pension fund might become worthless, and he would receive no pension.

Gainers and Losers

An employee who retires after a full career would gain enormously from privatization, as his pension would be far larger.

The employee's gain would constitute a *large* loss of tax revenue to the government, so presumably the government would raise other taxes to offset the loss.

A worker would not be permitted to manage his pension fund himself. The money would be managed by a professional money manager, who would receive a fee.

Wall Street salivates at the prospect.

Problem Solved?

A problem facing the government is how to pay future social security benefits.

In the long run, privatization would solve this problem, in the sense that the government would no longer have any obligation to pay a pension.

In the short run, the problem of paying the pensions of the baby boomers would remain.

Social Security Trust Fund

One reads in the newspaper about the "social security trust fund." Although the discussion solemnly proceeds as if this fund and its size were significant, in fact the fund is irrelevant and meaningless.

Suppose that you have a piece of paper in your pocket saying that you owe yourself $1 million. Does this paper make you wealthy? Indeed not, as the liability cancels the asset.

This situation characterizes the social security trust fund.