

Social Security in the United States - Systemic Problems and Reform Alternatives

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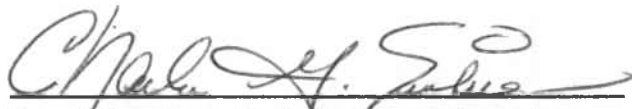
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SIGNATURE PAGE

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INTRODUCTION

This thesis briefly covers the topic of Social Security's financial problems and alternative methods of reform. It is a subject that most working Americans and beneficiaries hold near and dear to their hearts and wallets.

For all of the working years the employed have to contribute to Social Security, the least one would expect is financial security assistance from the system, when and if the need arises. Unfortunately, this may not be the case because Social Security may become insolvent in the near future. It may be headed toward financial ruin if drastic measures are not undertaken to resolve this dilemma.

Social Security insolvency is not inevitable, but politicians must be willing to confront the monumental task of overhauling the United States Social Security system. Politicians have had a "hands off" approach to Social Security reform since the mere mention of reform has meant political suicide. Unfortunately, because of the aforementioned, a solution to the Social Security problem may be a long way off.

Consider the various aspects of the Social Security system. Many questions about the Social Security system can be addressed. What are the history, structure and purpose of Social Security? What are some of Social Security's ailments and their causes? What are some Social Security

reform options and their strengths and weaknesses? This thesis will attempt to answer some of these questions.

The American public can no longer afford to think of Social Security as a sacred cow. Reforms are the system's only hope.

THE FOUNDATIONS OF SOCIAL SECURITY

Our social security system's main goal has been to replace income lost due to broad economic and social reasons. Another goal may be to provide a minimum financial floor of protection accomplished through the maintenance of a minimum income (Schottland p. 2).

There are many reasons for economic insecurity. Social security programs try to cover specific areas for the individual. These areas include unemployment, industrial accident, disease, old age, permanent disability, temporary illness and death.

All industrial nations have developed numerous types of social security programs to assist in providing financial security for their citizens. These social security systems have been developed based on each country's historical needs. Therefore, each system is unique in its own way. Each country has taken a different approach, with some systems being more successful than others.

The U.S. Social Security system was based on "The western frontier, the emphasis on self-help and voluntary programs, local self-government, states' rights--these and many other factors--political, economic, demographic, social and philosophical--have influenced its development (Schottland p. 4)."

A SHORT HISTORY OF THE U.S. SOCIAL SECURITY SYSTEM

The Homestead Act of 1862 allowed every head of a family or a single person over twenty-one years old to "homestead" 160 acres (a quarter section). Much of America's growth and prosperity, during the latter part of the 1800s, was attributable to this homestead policy (Schottland p. 19). The western frontier provided many opportunities while the industrial workers were feeling the economic effects of old age, unemployment and illness.

The United States had no public programs in place to provide any economic security for the masses. Private voluntary relief agencies attempted to provide sickness and old-age benefits to workers in the emerging U.S. industrial economy.

Each individual was responsible for his own welfare. This was the prevailing belief held by the American public at the turn of the 20th century. With millions of European immigrants converging on the United States and the growth of America's industrial efforts, it became evident that many people were unable to care for themselves.

There was widespread unemployment in 1906. Hit particularly hard were the industrial workers, but prosperity was again the theme in the United States after World War I. Many thought the country had reached "a permanent plateau of prosperity (Schottland p. 23) (Schlesinger p. 155)." The New York Stock Exchange

reached record highs in the summer of 1929. Americans became overly optimistic.

The boom of the 1920s ended with the stock market crash of 1929. Within weeks of the October 23 crash, the valuation of the stocks on the New York Stock Exchange had tumbled over 40 percent. Unemployment escalated. Farm and home foreclosures were common. Bread lines were in every major city. Local government and voluntary agencies quickly exhausted all resources. By December of 1930, it was estimated unemployment amounted to 12.5 million people. The economic and unemployment hardships brought on by the Great Depression were unprecedented. America was unprepared for such a calamity.

By 1932, President Hoover and federal officials still opposed any direct unemployment assistance. This was a peculiar stance, since it was evident that local and voluntary agencies could not cope with the worsening conditions.

Seven states financed unemployment relief by March of 1932. The states demanded federal assistance since they could not handle the situation by themselves.

"In the Presidential elections of 1932, the question of federal relief became a campaign issue. Franklin Delano Roosevelt, as Governor of New York, had sponsored the first state emergency relief program, and in his Presidential campaign he urged federal participation in relief programs,

public works and unemployment insurance." Franklin D. Roosevelt won the Presidency and felt "the election was a clear mandate to use the powers of the federal government to remedy the situation (Schottland pp. 23-25)."

A new era in federal government had emerged. Relief of destitution became the responsibility of the federal government. Many agencies were established and programs were implemented. The Civilian Conservation Corps and the Rural Rehabilitation Program were early examples of Roosevelt's New Deal policies.

Before the Depression, federal leaders opposed any federal assistance for social insurance and public assistance. This coincided with the prevailing American philosophy that poverty resulted from laziness and failing to provide for one's own future. The Great Depression changed the way Americans thought about economic security. Millions of hard-working and independent workers were unable to find employment due to conditions beyond their control. Many New Deal programs had a profound positive influence on the American people. It was generally felt that the beneficial aspects of these programs should be permanently preserved.

The push for social insurance grew. Most states had carried some form of workmen's compensation. The Democratic party promoted unemployment and old-age insurance. By June of 1934, the President appointed the Committee on Economic

Security. This was the first step in setting up measures to protect Americans from economic insecurity. The Committee laid the groundwork for a comprehensive program of social security. President Roosevelt signed the Social Security Act on August 14, 1935.

Social security has been adopted in the United States because of the realization that wages can and do stop when certain contingencies arise, that many persons find themselves destitute for reasons beyond their control, and that certain government programs and services are essential to assist the individual in his (her) own efforts to achieve support and economic and social independence (Schottland p. 33).

W. L. MacKenzie King, a former Canadian Prime Minister, realized the vital importance social security programs play in the modern world. In 1942, MacKenzie King declared, "The era of freedom will be achieved only as social security and human welfare become the main concern of men and nations (Schottland p. 1)."

SOCIAL SECURITY IN THE UNITED STATES

Social Security is a federal government system consisting of many social programs. These programs are designed to assist in providing income security for individuals in the events of old age, disability and unemployment (Hyman, 1996, p.259).

Social Security is a mandatory contributory (through taxation) insurance program for most of the U.S. workforce. The benefits are paid as a matter of "right," not the discretion of administrators. It is a right that arises out of working and out of the payment of special taxes on the earnings from that work. These taxes are usually deducted from employee wages and salaries. The deductions are typically noted on the pay stub as FICA (Federal Insurance Contribution Act).

Social Security is funded entirely by employee, employer and self-employed contributions placed in trust funds. No government subsidies are provided by general revenues from the federal government. The benefits are based on the employee's earnings history and no "means test" is required (American Academy, 1995, p.33) (Ycas, 1994, p.3). This thesis will focus on the government-provided pension program aspect of Social Security. This consists of OASDI (old age, survivors, disability and insurance), administered by the federal Social Security Administration.

SOCIAL SECURITY ORIGINS, INTENTIONS AND STRUCTURE

Social Security originated under the presidency of Franklin D. Roosevelt. In 1935, the United States was in the midst of the Great Depression. Jobs were hard to come by and the elderly were economically vulnerable. Social insurance was the right answer for those times. It culminated with the passage of the Social Security Act of 1935.

The basic premise and goal of the OASDI program are that all persons who work, whatever income level, type of employment, citizenship, age or other special characteristics, should be covered by the system. This is an attempt at universal coverage. Employment is a key concept in coverage (Schottland p. 36).

One main strength of the Act may also be a main weakness. It provides all qualified workers an earnings-related benefit. Providing benefits to retirees (for example) would protect Social Security from political attack. President Roosevelt had the foresight to have a separate payroll tax withheld just for Social Security. He once said, "no damn politician can ever scrap my Social Security program" (Church, 1995, p.32). So far, he has been right.

The original intention of the program was to provide social insurance for workers and their families from the economic impact of old age, poor health, death and

disability. Benefits were balanced between "individual equity" and "social adequacy" (American Academy, 1995, p.33).

Social Security is structured as a "pay-as-you-go" system. This system pays today's benefits with today's taxes (Samuelson, 1995, p.37). It is this financial "contract" between workers and pensioners that keeps Social Security functional.

The tax money received for Social Security goes into trust funds. These include the Federal Old-Age and Survivors Insurance Trust Fund, the Health Insurance Trust Fund and the Federal Disability Insurance Trust Fund (Schottland p. 56). The trust funds are kept completely separate from other funds in the General Treasury. A certain amount is kept in cash to take care of current cash expenditures. The remainder is invested in government securities.

There have been alternate methods considered, in the past, to investing this vast amount of money. All of the alternatives resulted in the conclusion reached by the 1959 Advisory Council, which is still followed this very day. They recommended that

investment of the trust funds should be, as in the past, be restricted to obligations of the United States Government. Departure from this principle would put trust fund operations into direct involvement in the operation of the private economy or the affairs of state and local governments.

Investment in private business corporations could have unfortunate consequences for the social security system--both financial and political--and would constitute an unnecessary interference with our free-enterprise economy. Similarly, investment in the securities of state and local governments would unnecessarily involve the trust funds in affairs which are entirely apart from the social security system (Schottland p. 61).

Of course, the federal government does not let this money just sit there. The surplus is invested in Treasury bonds and this helps (via accounting wizardry) to offset the federal deficit by billions of dollars. Eventually, the federal government must redeem the bonds (after the borrowed money has long been spent) and pay back the trust funds as greater demands are placed on Social Security and present surpluses dwindle. Alternatives such as borrowing from the public, raising income taxes, cutting spending or a myriad of other possibilities are all unappealing (Church, 1995, p.27).

WHY SOCIAL SECURITY'S STRUCTURE NO LONGER WORKS:

DEMOGRAPHIC CHANGES

Through the decades, Social Security has been slightly modified. The system's design has been based on the assumption that many aspects of society would remain similar over time (Ycas, 1994, p.4). Unfortunately, Social Security cannot accommodate many demographic changes. Hence, through the years, Social Security policy changes that have occurred have been reactive in nature. No major design changes have been bestowed upon the Social Security system to resolve its pending financial crisis. Simply put, the general trend for Social Security has been toward higher increases in costs compared to decreases in revenues (Ycas, 1994, p.4). The trustees of the Social Security system have concluded and admitted that the system is not in "actuarial balance," meaning expected income will not cover expected costs (Boltz p. 10). Demographic changes have exacerbated the problem.

Public confidence in Social Security has deteriorated. In a 1991 study, 61 percent of non-pensioners had little confidence Social Security would have the money to pay them upon retirement. The result is a generational conflict of interest. While the older generation currently relies heavily on Social Security, the younger generation (the ones paying for today's benefits) doubt the bargain will be kept for them at retirement. If the support for the system

continues to erode, the consequences could be serious for all involved (Ycas, 1994, p.8).

The first Social Security checks were mailed in January 1940. At this time 220,000 people benefited from these payments. In 1994 there were forty-two million people receiving Social Security benefits (Ycas, 1994, p.3). One major demographic change has been the increase in population. The population boom has been the result of people living longer and more babies being born (two more demographic changes). Since 1935 (the inception of the Social Security Act) people benefit from healthier living conditions and work is less physically demanding. They have better medical care and have a lower risk of getting infectious and acute diseases (Economist Staff, 1996, p.11). Infant mortality rates have declined.

An anomaly to the population increase has been the generation of the "baby boomers." This is the generation that encompasses babies born between 1946 and 1964 (McConnell, 1993, p. 575). The age distribution of the work force has been adversely affected by this anomaly. As the "baby boomers" start retiring, systemic financial problems for Social Security will worsen.

Although more babies are being born, the birthrate has been declining. This is important information when determining the worker-to-retiree ratio. The ratio explains how many workers are supporting retirees through the Social

Security pay-as-you-go system. In 1950 there were sixteen workers paying taxes for each Social Security pensioner. Currently, there are approximately three workers for each pensioner. By 2030, based on projections, there will only be two workers for each retiree receiving benefits. The latter ratio reduction will be due mainly to the influx of baby boomers in retirement. This could put an immense tax burden on workers if drastic measures are not undertaken to overhaul the Social Security system.

The changing dynamics of the family structure greatly affects Social Security. If people marry at all, they tend to marry and bear children later in life. Many children, compared to the past, are born out of wedlock. The typical family of today is not structured the same as the conventional family of the past consisting of husband, wife and children. Many households with children are headed by single women. Females earn less than males in their working careers. Since Social Security benefits are to provide financial adequacy, additional households with lower wage earners will burden the system.

Social Security was designed in an era where the husband spent most of his life in full-time employment. The wife stayed home and did the child rearing and relied on her husband for financial support. Now many women are in the workforce. Even with role changes, Social Security benefits have not adapted to the women's contributions to the system.

The benefits paid are based on the higher of the spouse's wage earnings and typically this is the male's earnings. Hence, the majority of women receive payments that have no bearing on their contributions to the system through the years. Because of this, women are not treated as well by Social Security.

Unskilled worker earnings is one troublesome area. The number of jobs and the corresponding wages they pay, for unskilled workers, have been trending downward. This puts a previously economically marginal group into a worse financial position than before. This group will pay Social Security at lower rates (decreasing revenues to Social Security) and their benefits at retirement will be lower. Thus, their standard of living at retirement will be lowered (Ycas, 1994 pp.3-9).

The average American's household (personal) savings rate has been historically low and continues to trend downward. From 1950 to 1979 the household savings rate, as a percentage of GNP, was 5 percent. From 1980 to 1991 it was 3.7 percent (Hyman, 1996, p.415). Currently, it is 3.2 percent of GDP (Koselka, 1995, p.70). Lower personal savings and investments equate to lower income for today's workers once they retire. This puts a further burden on an overburdened Social Security system. The system was not designed, necessarily, to help those who are unwilling to help themselves. This is one area of social insurance where

a real problem may exist. Why should those individuals who "live for the moment" be a burden to those who save? This makes no sense.

Personal finance is analogous to a three-legged stool. There is Social Security (hopefully), personal savings and company pensions. The job market is unstable with company downsizing. Young people entering the job market now are forecast to change jobs ten to eleven times throughout their working years (Foster, 1994, p.46). Long-term employment with a single employer is the exception more than the rule. This creates a problem with company pensions. Pensions are based on the factors of longevity, vesting and employee earnings with a corporation. With the job market turnover, these factors for short-term employees never materialize or the pensions are small. There is very little pension portability from job to job available. In essence, the three-legged stool is in jeopardy. Social Security is headed for financial problems. Personal savings rates are heading downwards. Company pension benefits are less for employees working for multiple employers throughout their careers. This is an additional burden to our social insurance program.

Some companies are reducing their workforce by offering early retirement incentives. Potential years of Social Security revenues will be lost the moment these individuals

retire. Once they are Social Security eligible, they will draw benefits from the system. This is detrimental to a pay-as-you-go system.

THE POTENTIAL MELTDOWN OF SOCIAL SECURITY

The trend of the worker-to-retiree ratio is heading downward. This is the result of the complexities involved concerning the change in demographics in our society. The costs will eventually overrun the revenues of our pay-as-you-go system.

When the Social Security trust fund will go into deficit and insolvency is open to debate. The National Tax Journal states that the fund "is scheduled to go into deficit in 2015" (Gruber, 1995; p.159). Time magazine notes various estimates varying from 2013 to 2019 (Church, 1995, p.27). U.S. News & World Report states that "Social Security will start running cash-flow deficits in the year 2013, meaning its annual payouts will exceed its annual tax intake, and exhaust its reserve (trust) fund by 2029 (Hage, 1995, p.47)." Once the trust fund is exhausted, it is insolvent. USA Today (Magazine) states that the "Social Security trust fund will be insolvent by 2031 (Schnepper, 1995, p.29)." Under its current design, Social Security is headed toward insolvency. The numbers do not add up. Costs will exceed revenues. It is no surprise that our social insurance system requires major reform. Even with the predictable demographic changes, the financial problems with Social Security are not imminent enough to create a sense of urgency. Perhaps, therein lies the problem.

WHY POLITICIANS WILL NOT TOUCH SOCIAL SECURITY REFORM

Social Security reform is a quick ticket to political suicide. Former House Majority leader Tip O'Neill once said, "Social Security is the third rail of politics. Touch it and you die!" (Hogeboom, 1995, p.12) Few politicians have even dared to criticize Social Security let alone mention reform.

Retirees and those nearing retirement are a special interest group with political clout. Any politician who considers Social Security reform, such as a decrease in pension benefits, will be punished. This is the "electoral equivalent of burning at the stake" (Church, 1995, p.26). Unfortunately, this is a reflection of our society. We are unwilling to incur short-term costs to reap long-term benefits. This holds true for Social Security reform, business, and many other aspects of our society. We are constantly focused on the bottom line and the short-term view. The long-term view is not generally ingrained into the American psyche. It appears that Social Security reform will not be seriously considered until the crisis is imminent. Then, reform will probably be far more costly. Social Security may be a political and social time bomb waiting to explode. Ironically, society may know this and still be unwilling to do anything about it.

REFORM OPTIONS

There are numerous Social Security reform options. If our society decides that Social Security is a viable program, reform is imperative. Here are some pros and cons of each alternative. This is not an all-inclusive list.

1. Benefit reductions

Reductions could be accomplished in a variety of ways. Cost-of-living adjustment (COLA) increases are based on the Consumer Price Index (CPI). These increases could be reduced. This would save much money. Pensioners would lose purchasing power in the long-run because of inflation outpacing COLA increases.

Percentages in the initial benefits formula for calculating benefits could be reduced and save money. An across-the-board cut would hurt the low-income pensioners the most. The change could be done to protect the low-income recipients. Alas, any tinkering with current and future benefits (the "sacred cow") is unpopular with the elderly and near-term retirees (American Academy, 1995, p.35).

2. Raise the retirement eligibility age

Full pension benefits are available at age sixty-five. Partial benefits for early retirement are available at age sixty-two. From 2003 to 2027, full pension eligibility will slowly be increased from age sixty-five to age sixty-seven (Hyman, 1996, p.272). The full retirement age could be

increased even further and the age increases could be accelerated (American Academy, 1995, p.34). Early retirement eligibility could be eliminated or the age increased accordingly (Church, 1995, p.30). This would increase Social Security revenues and reduce pension spending simultaneously, but near-term retirees would not want to have to wait longer for their "earned" benefits (Economist Staff, 1996, p.4).

3. Shift to a "means-tested" system

With a means test there would be a high minimum benefit. There would be steep reductions in benefits for higher income or wealthier retirees. Decreased pensions for higher income or wealthier retirees and increased pensions for lower income pensioners would help assure that there would be a minimum standard of living for retirees (Gruber, 1995, p.160). This could entice high income earners to conceal income and wealth (Church, 1995, p.31).

4. Change the taxation structure

Currently, the tax rate for Social Security is 6.2 percent for employees and 6.2 percent for employers. A simple solution is to soak the taxpayer for more money. Combined employer-employee tax rates for Social Security and Medicare were 2 percent in 1937. Currently it stands at 15.3 percent, where 2.9 percent of that is Medicare (Hyman, 1996, p.273). With all of the other taxes that taxpayers

are responsible for, how can we, as a society, keep paying higher and higher taxes?

Limits on taxable earnings for Social Security could be increased or eliminated. The current ceiling for taxable earnings is \$61,200. The tax is regressive since the earnings are capped and it does not tax unearned income (Gruber, 1995, p.162).

Another unappealing choice is to increase the taxation of those receiving benefits. Retirees on fixed incomes would not opt for this plan.

Finally, taxation for Social Security could be expanded (American Academy, 1995, p.34). State and local government employees could pay into the system. Unearned income could be taxed. The taxable earnings ceiling of \$61,200 could be lifted. Any party affected by these proposals would find them unattractive.

5. Change the trust fund investment scheme

The Social Security trust fund is required by law, to invest only in U.S. government bonds. Over the long run, equity markets (such as common stock) outperform the bond market, especially the U.S. government bond market. Investing in the equity market could be an attractive alternative to investing in U.S. bonds. Equity markets can be more volatile in the short-term (American Academy, 1995, p.34).

6. Financing from the general treasury

Financing could be from direct government subsidies. There could be value-added taxes (a national non-payroll tax) to fund Social Security. If this were to take place, Social Security would no longer be the self-supporting program it was designed to be. At this point we are starting to get away from the "earned" benefits rights of pensioners (American Academy, 1995, p.38).

7. Partial or complete privatization

The country of Chile is an excellent example of successful Social Security reform. Chile originally had a Social Security system modeled after the U.S. system. By the mid-70s, Chile was experiencing the Social Security financial meltdown we may be headed for. Forecasts of tax rates approaching 65 percent were made to finance the Social Security benefits (Hyman, 1996, p.261). In 1981, Chile pioneered a "two-tiered" system. One tier is funded out of the government's general revenues and the benefits only go to the poorest pensioners. In the second tier, all workers are required to put 12 percent of their wages or salaries into twenty-four private and government regulated investment funds (Church, 1995, p.30). The second tier is the major tier and is the privatization part of the system. The annual real returns for the Chilean system have been far higher (12%) than the U.S. system (2%) (Hyman, 1996, p.261). On the positive side, Chilean savings rates have skyrocketed

to 29 percent compared to the paltry 3 percent in the United States (Church, 1995, p.30).

The U.S. Social Security system could model itself after the Chilean "two-tier" system. Most employee wages or salaries would be placed in mandatory IRAs. These IRAs would be private and government regulated. People could self-direct their investments as conservatively or aggressively as they want, within the IRA universe available. The first tier would, essentially, be a fully funded pension system. The second tier would require payment to the government, via taxes, to pay for current pensioners and those soon to retire (a pay-as-you-go system). Younger workers would have to depend mostly or entirely on savings in their mandatory IRAs (Church, 1995, p.31).

The IRA-type accounts would be owned by the individuals who contributed to them, not to those who did not contribute. This is a shift from social adequacy toward individual equity and a major change from the original social adequacy concept of social insurance (American Academy, 1995, p.36).

There are several advantages to privatization. Taxes paid actually represent individual retirement savings. Individuals could select their own retirement dates since they would be drawing on their own savings. Public transfers from the rich to the poor and from the young to

the old would be reduced. The private pension would be a better investment over the long-run. Real returns on Social Security for those born after 1960 equate to approximately 2 percent annually. The real returns on the U.S. stock market have been around 5.5 percent annually (Hage, 1995, p.47).

Privatization would shift retirement planning to the individual instead of spreading the risk through Social Security as it stands today. Private pensions would be vulnerable to the volatility of the stock and bond markets.

There are large costs associated with privatization. Transition costs would occur to pay off the generation of retirees who have already paid into the current system (Gruber, 1995, p.16). "The Social Security Administration estimates that Washington would have to come up with a staggering \$8 trillion in new revenues to tide the system over until personal retirement accounts take over in the next century (Hage, 1995, p.47)." Would the current workers pay them off? Would the government?

People with long and steady careers and good investing strategies may find the private pension option beneficial. Individuals with low wages, part-time workers and those who drop out of the labor force at times may not be able to contribute enough to provide an adequate standard of living upon retirement. The current redistributive effect of Social Security would be lost.

CONCLUSION

In 1920, Mr. Charles Ponzi was exposed as a con man who promoted an investment that paid huge returns to current investors from money provided by new investors. This kind of financial fraud became known as a "Ponzi Scheme." When we examine the pending financial crisis of our Social Security system, it appears to have the characteristics of a government-sponsored Ponzi Scheme.

Contributions by current retirees during their working years were too low for funding today's benefits. The system now depends on contributions from today's workers to fund these benefits. Coupled with ever-rising benefits mandated by Congress over the past 30 years, today's workers now have to support today's and tomorrow's retirees. The similarities to a Ponzi Scheme are uncanny.

Our Social Security system is headed toward insolvency. Without major reform, there will be no Social Security. Our society has to determine if Social Security should be salvaged.

If Social Security is worth saving, major reform is mandatory. There is a myriad of reform proposals. No single alternative is a panacea. The best reform would be a combination of alternatives.

Delays in fundamental reform of our Social Security system will result in higher costs. Without question, now appears to be the time for reform.

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