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DOES GALVESTON OFFER A MODEL FOR SOCIAL SECURITY REFORM?

By Jason Furman

Some, including President Bush, have pointed to the experience of Galveston, Texas as demonstrating why private accounts should be incorporated into Social Security. In 1981, Galveston and two other Texas counties opted out of Social Security and established their own substitute Social Security systems for county employees.¹ Their plans provide retirement, survivors, and disability benefits.

These plans, however, do not provide evidence that the President's approach could be successful, for three basic reasons.

- **The Galveston Plan bears little resemblance to the President's plan.** The Galveston plan does *not* have voluntary private accounts. Instead, the county invests pension funds in the market; individual workers do not have accounts or any control over investment decisions. In addition, participation in the Galveston plan is mandatory. The Galveston Plan also features higher payroll tax contributions: 13.9 percent of payroll, as compared to 12.4 percent under the traditional Social Security system.²
- **Retirement benefits are generally lower under the Galveston Plan.** Under the Galveston Plan, *initial* retirement benefits are lower for many workers than under Social Security. Furthermore, unlike Social Security, the Galveston plan does not adjust benefits from year to year to reflect increases in the cost of living. As a result, according to a Social Security Administration study, "After 20 years, all of Galveston's benefits are lower relative to Social Security's." The SSA study also noted that "there are no additional spousal or dependent benefits... benefits are not portable to future employers; benefits are not adjusted for inflation; and, in general, benefits are lower for those with lower earnings and/or with a greater number of dependents who qualify for Social Security."³

¹ Prior to the 1983, states and municipalities could opt of Social Security. The 1983 Social Security legislation ended this practice but grandfathered in states and municipalities that had already opted out of Social Security.

² Galveston also has a supplementary pension plan, comparable to state and local government pension plans.

³ Theresa Wilson, Office of Policy, Social Security Administration, "The Galveston Plan and Social Security: A Comparative Analysis of Two Systems," *Social Security Bulletin*, 62:1, 1999.

- **Galveston could not provide a model for the country as a whole.** The 5,000 municipal employees covered by the plans run by Galveston and the two other Texas counties opting out of Social Security do not make any contributions to support current Social Security beneficiaries. If the United States as a whole adopted a Galveston-like plan, *there would be no one left to pay the \$500 billion annual cost of benefits for the nation's 45 million current Social Security beneficiaries.*

In other words, municipal employees from these three Texas counties are “free riders” who are escaping their share of the national obligation to finance Social Security for current retirees. The United States as a whole cannot “free ride” in the way that government employees in one relatively small county can.

The remainder of this brief analysis explains in more detail why the experience in Galveston has little relevance to the current national Social Security debate and why claims that the Galveston experience shows that we should move to private accounts are erroneous.

The Galveston Plan Bears Little Resemblance to the President's Plan

The President has proposed voluntary private accounts. Workers would manage their own money, with limited investment choices. A retiree's benefit would depend on how his or her investments performed. The President has argued strongly against *government* investment of the Social Security trust fund.

The Galveston Plan, however, *is* government investment, not private investment. Workers have no say over the investments, and the earnings on the government investment inure to the benefit of the retirement fund as a whole, not to individual workers. In addition, participation in the plan is mandatory.⁴

The President has ruled out any increase in the payroll tax rate, stating that his plan needs to be funded entirely out of the current 12.4 percent payroll tax. But Galveston county raised the payroll tax rate to 13.9 percent when it opted out of Social Security.⁵

Retirement Benefits Are Generally Lower Under the Galveston Plan

The Galveston plan does not provide any benefits for spouses or other dependents of retirees. Nor does it provide any redistribution from higher earners to lower earners. In addition, the Galveston Plan fails to provide an inflation-indexed annuity — participants can choose a combination of lump-sum payments or a variety of fixed annuities that do not increase with inflation (and thus that erode in value over the course of a beneficiary's retirement years). Finally, the Galveston plan allows early withdrawal of account balances in several cases (such as serious illnesses

⁴ Galveston is a defined contribution plan only in the sense that workers' ultimate retirement benefits are a function of their contributions plus the interest earned on the trust fund.

⁵ Workers contribute 6.1 percent, and the county contributes 7.8 percent. Economists agree that the employer share of such taxes is effectively borne by the employees.

or certain other problems), which reduces the ability of the plan as a whole to provide income for as long as beneficiaries live and thereby increases the plan's costs. (This is one of the reasons that the tax rate is higher under the Galveston plan than under Social Security, even though the retirement benefits are generally lower under the Galveston plan.)

The Social Security Administration's Office of Policy conducted a study of the Galveston plan. It found that benefits under the plan are generally inferior to those that Social Security provides:⁶

- The Galveston Plan “offers a lower *initial* ongoing benefit than Social Security for single workers with low earnings and for married workers at the low, middle, and high earnings level” (emphasis added).
- The Galveston offers lower *subsequent* benefits for nearly all workers because the initial benefits are eroded by inflation: “after 15 years Galveston's benefits are lower than Social Security's for all family/earner types with the exception of single, very high earners. After 20 years, all of Galveston's benefits are lower relative to Social Security's.”

The Social Security Administration study also found that the comparison of disability and survivors benefits under the Galveston plan to those that Social Security provides depends on an individual's specific circumstances, but that in general, people who receive these benefits for longer periods of time would be worse off under the Galveston plan because the benefits under that plan fail to keep pace with inflation.

Galveston Cannot Provide a Model for National Social Security Reform

When Galveston county opted out of Social Security, it was essentially “free riding” on the rest of the country. Galveston county workers do not provide any contributions to support current Social Security beneficiaries, including former Galveston county workers who retired prior to implementation of the county's system in 1981. Only about 5,000 employees participate in the plans run by Galveston and the two other Texas counties opting out of Social Security,⁷ so these counties' opting out of Social Security has a negligible impact on the finances of the program as a whole.

But the Galveston model would be impossible to replicate on a national scale. If Americans in general redirected all of their payroll taxes into new private plans, there would be no tax revenue left to pay the \$500 billion in annual benefits promised to Social Security's 45 million current beneficiaries. Those benefits consequently would have to be funded by income taxes or an entirely new tax, such as a Value Added Tax. Even if the new private plans *appeared* to provide a better deal than traditional Social Security (which is not case with the Galveston plan), that apparent free lunch would evaporate once the cost of the additional taxes needed to support current beneficiaries was factored into the equation.

⁶ Theresa Wilson, Office of Policy, Social Security Administration, “The Galveston Plan and Social Security: A Comparative Analysis of Two Systems,” *Social Security Bulletin*, 62:1, 1999.

⁷ Kris Axtman, “No Plan is an Island: Galveston's Experiment,” *Christian Science Monitor*, May 4, 2005, p. 3.