The American System of Social Welfare:
A Special Roper Center Review of Data on the Programs and Public Thinking about Them (Social Security: pp. 16-27, Means-Tested Programs: pp. 35-46)

The Economics of an Aging Social Security Program

By Carolyn L. Weaver and Derrick A. Max

Under the government's official long-range projections, released each spring by the system's Board of Trustees, Social Security has been operating with a long-range deficit virtually every year since 1983, when Congress last "fixed" it. Based on the Trustees' "best guess" assumptions, the deficit has more than doubled in the past five years alone and is now larger than it was in 1982 when a cash-flow crisis was imminent and the long-range situation was viewed as untenable. The nation's giant public retirement program is not projected as able to meet all of its long-range obligations as they come due.

Created in 1935 as the cornerstone of the New Deal, Social Security originally consisted of just one compulsory program, the retirement program, which is referred to as Old-Age and Survivors Insurance. Disability Insurance was added in 1956, and Hospital Insurance (Part A of Medicare) was added in 1965. Together, these programs spent $432 billion in FY1994—about $1 out of each $3 spent by the Federal government—on 42 million people. The cost of these programs is met primarily through a payroll tax of 15.3%, split evenly between employers and employees. While some people (including many politicians) seem to believe that the employer portion of the tax is a gift (or "contribution") made on behalf of employees, economists generally agree that the tax is paid by employees in the form of reduced wages. For this reason, the combined employee and employer tax is used when evaluating a worker's tax payments or the relationship between a worker's benefits and taxes paid.

Social Security has historically been financed on a pay-as-you-go basis. Benefits to current retirees are paid for by taxes on current workers, and there is no significant accumulation of assets against accruing liabilities. The typical pay-as-you-go system therefore operates with a very large unfunded liability. The long-term viability of such a system depends on the willingness of workers to continue financing benefits for retirees in the expectation that they too will receive benefits when they retire; and it depends on the confidence workers place in an implicit compact with future generations of workers.

While some people seem to believe that the employer portion of the Social Security tax is a 'gift' made on behalf of employees, economists generally agree that the tax is paid by employees in the form of reduced wages.

Workers often question whether they will get their "money's worth" under Social Security. Will the taxes they are paying be returned with any interest, and if so, will the interest be comparable to what they could have earned on alternative investments? Since Social Security redistributes income both between and within generations, the answer varies widely for people in different generations and with different work and family patterns.

Intergenerational Transfers

In the start-up phase of a pay-as-you-go retirement system, those who are already elderly fare extremely well. Taxes collected from workers are paid out to people near retirement, who have paid little or no taxes. The implicit interest rate (or real rate of return) on taxes for these retirees is very high. As succeeding generations reach retirement, having spent an increasing share of their work lives paying taxes into the system, benefit levels rise due to the growth in taxable wages, but their rates of return on the taxes fall. Ultimately, under a mature pay-as-you-go system, when everyone has paid taxes over their entire work life, the maximum rate of return that can be paid is equal to the rate of growth of real taxable wages in the economy. This is roughly equal the rate of growth of productivity plus the rate of growth of the population, which is only about 1-2% in the United States. These rates of return refer to the average that can be paid to each cohort of retirees during the maturing of a pay-as-you-go system.

Recent data support the conclusion that rates of return for succeeding generations have dropped dramatically as our Social Security system has matured. Geoffrey Kollmann of the Congressional Research Service reports that a worker with average wages retiring in 1940 recovered the retirement portion of his or her taxes (including the employer's payment), plus interest, in just 2-1/2 months. The figure for a similar person retiring in 1960 is just over 13 months, and for a person retiring in 1980 it is projected to exceed 33 months. This trend worsens for current and future retirees. The expected payback period for those retiring in 1995 is 13.1 years, increasing to 19.0 for those retiring in 2005, 21.5 for those retiring in 2015, and 21.8 for those retiring in 2025—with the figures for each cohort after 1995 exceeding by several years the projected life expectancy of men.

Similarly, Michael Boskin, former chairman of the Council of Economic Advisors, and his colleagues have esti-

mated that a worker with median earnings (and a non-working spouse) who retired in 1980 can expect a real rate of return on taxes of 5.5%, as compared to only 2.1% for 2010 retirees, and only 1.5% for 2025 retirees. The expected net loss for the 2025 retiree is $48,000 in present value terms, as compared to a net gain to the 1980 retiree of $63,000. *Returns are even lower, in some cases much lower, for two-earner couples.*

Calculations such as these, it should be noted, are based on current-law taxes and benefits. Since Social Security is not in long-range actuarial balance, however, there must be increases in future taxes, reductions in future benefits, or both. How Congress decides to allocate these costs will have a significant impact on rate-of-return calculations and on the economic well-being of current and future retirees.

Intragenerational Transfers

Social Security redistributes income not only between generations but also within generations. For example, the spouse benefit subsidizes workers in families with one breadwinner and a non-working spouse, while the weighted benefit formula subsidizes workers with low average earnings. These subsidies come at the expense of workers in two-earner couples, single workers, and workers with higher average earnings. Additionally, the retirement earnings test and the actuarial adjustments for early and delayed retirement subsidize workers who retire at sixty-five (and possibly earlier) at the expense of those who retire later. These cross-subsidies can be quite substantial and can have a significant effect on whether or not an individual or couple will get its money's worth from Social Security.

As rates of return fall and pay-back periods climb, workers are beginning to compare the interest they can expect to earn on their Social Security taxes with the interest they might have earned on their own private savings. For those who are not expected to fare well—many of those born in 1945 or later, particularly high-wage workers—the difference in interest rates is the "opportunity cost" of investing in unfunded government debt rather than in real capital. Confidence in the system can be expected to deteriorate as real and perceived losses mount.

In addition to its direct effects on income, many economists believe that Social Security has an indirect impact on national income by reducing personal savings. Economist Martin Feldstein argued in 1974 that under a pay-as-you-go retirement system, people substitute government promises of future retirement benefits for their own retirement savings. Feldstein estimated that this substitution had decreased personal savings by one-third. Lower private savings, when not offset by increased government savings, results in lost productivity and output and lower future real incomes. Feldstein's empirical results have been challenged, and his estimates subsequently revised downward. While evidence to support or refute his view is mixed, many economists believe that pay-as-you-go financing of public retirement systems depresses personal savings. How large the effect is remains in question.

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Daunting Liabilities Loom

In 1983, Congress approved legislation that included a gradual increase in the Social Security retirement age, hefty increases in the payroll tax, and other changes intended to shore up the system in the long range. The net effect of these changes was to move the system from strict pay-as-you-go financing to partial advance funding. Social Security is now running annual surpluses, on the order of $53 billion in 1994, and accumulating a reserve fund estimated at $430 billion ($560 billion including Medicare) at the end of 1994. The reserve is projected to peak at $1.3 trillion (in constant 1994 dollars) in the year 2015. After that, large deficits are projected to deplete the reserves and ultimately, in 2029, render the program insolvent. Under more pessimistic assumptions, insolvency occurs much earlier.

While advance funding has the appearance of fiscal responsibility, it is important to note that the amounts being set aside, while substantial, are dwarfed by the size of the unfunded liability. Unpublished data from the Social Security Administration places this liability at over $8 trillion (excluding Medicare, as of January 1, 1994). As the actuaries have been warning, this liability (promise) can not be met with current tax rates.

In addition to looming liabilities, many economists argue that the monies being set aside in the trust fund are more an accounting illusion than assets backed by real capital. Currently, any surplus revenues are invested in special-issue government bonds. The trust funds are credited with a bond while the Treasury gets the cash, which it can spend like any other government revenues. In essence, the bonds in the trust funds are like large IOUs from one part of the government to another. Real savings can occur only if the government uses the excess monies to lower the public debt outstanding—which, in turn, can be accomplished only if Congress resists the temptation to relax fiscal restraint in the rest of the budget. If, instead, Congress uses the surpluses to finance deficit increases in the rest of the budget—that is, to fund current consumption—there is no real saving and income taxes will have to be raised (or government spending cut) when those IOUs come due. Congress

must also resist the temptation to spend the surpluses directly by expanding Social Security or bailing out Medicare, which is slated for insolvency within seven years.

In the near term, prospects for reforming the system do not appear to be good. The new Republican leadership has pledged to take Social Security off the table for the next 5 or 10 years. Not to be outdone, the White House has also promised not to touch it. If Congress sticks to this time-table, the baby-boom generation will be nearing retirement, the benefit and tax adjustments required to close the long-range gap will be larger, and the ability of workers and retirees to alter their work and retirement plans to offset the effect of these changes will be more limited. In the meantime, public confidence in the viability of the system, already shaky, will surely deteriorate further. These factors suggest that sensible reforms are more likely to come about if enacted sooner rather than later.

Needed Reform

With a system as large and complex as Social Security, there are many ways to trim long-range benefits and bring costs back into line with available resources without unduly affecting those near retirement. Proposals frequently mentioned include gradually increasing the retirement age to 68 or 70 and slowing the growth of initial benefits for people coming onto the rolls in future years. These proposals are among the numerous options compiled for the 1994 Bipartisan Commission on Entitlement and Tax Reform, which was co-chaired by Senator Rob Kerrey and former Senator John Danforth.

Recognizing the importance of eliminating the system's long-range deficit and also shoring up confidence among younger people, Kerrey and Danforth developed a reform package that would not only reduce long-range benefit growth but also convert a portion (1.5%) of the payroll tax to a mandatory IRA contribution. Workers would have their own individual accounts and be able to draw on the proceeds in retirement.

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Proposals to substitute mandatory saving plans for some or all of the Social Security retirement program builds on the work of Nobel Laureate James Buchanan, who has argued for allowing individuals the flexibility to control the investment of their Social Security taxes and to permit companies to compete for their business. Along these lines, for example, some have argued for moving toward a two-tiered system that would provide a basic floor of protection for the elderly, through a flat or means-tested payment, coupled with a mandatory savings component, which would pay benefits based on individual contributions plus interest. The first tier could be financed out of general revenues, while the second tier could be built on the current payroll tax, with revenues funneled directly into personal savings accounts. Under the second tier, assets would equal accrued liabilities. Such a system could simultaneously meet the needs of the elderly poor and the retirement income needs of workers as a whole, while promoting national saving and economic growth.

These are but a few of the options that have been developed. With the first wave of the baby-boom generation reaching 60 in just 12 years, there is every reason for Congress to move quickly to reform Social Security.

Recommended Reading

Carolyn L. Weaver, ed., *Social Security's Looming Surpluses: Prospects and Implications* (Washington, DC: The AEI Press, 1990).

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