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HIGHLIGHTS

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Safeguarding Social Security

Walter M. Cadette

Social Security faces an uncertain future. The combination of the baby boom's coming retirement and increasing life expectancy promises to drive the ratio of workers to retirees down to 2 to 1 some 30 years hence, half of what it was some thirty years ago. The system can maintain benefits for the next several decades at current tax rates by drawing down the reserves it is now able to accumulate during an era of demographic calm (although this will complicate other governmaent obligations because the return on the reserves finances other parts of the budget. But Social Security cannot make good on its benefits promises in the longer run without significantly higher payroll taxes or without adding to the returns on reserves. The imbalance Social Security faces is just over 2 percent of taxable payroll if it is addressed now. But the cost will mount as time passes.

The challenge to Social Security is twofold: to bring the system into long-run financial balance while preserving its popularity and to set a course for the system that is in balance with all the other obligations of government. Support of the elderly and the near-elderly under Social Security and publicly financed health care programs already requires an overall tax rate approaching 10 percent of GDP; it can go only up from there, quite possibly doubling within the next few decades. Government's ability to meet all its other obligations will be in question even more than it is now.

How might the nation change the system in order to correct the long-term financial imbalance Social Security faces as it meets the new demographic exigencies? One of two visions of Social Security's future would keep the system much as it is today, but revise benefits formulas, alter taxation, and, possibly, allow the system to invest in high-yielding equities. The other would "privatize" Social Security, grafting onto it an individually managed defined-contribution plan and shrinking its public benefits. These are the main lines of the competing approaches sketched out in the report of the 1994-1996 Advisory Council on Social Security (1997) released earlier this year.[1]

The broad public policy issue is which of Social Security's goals--individual equity (which is reflected in benefits according to a worker's lifetime earnings) and social adequacy (which is reflected in progressive benefits)--should get more emphasis if righting the system's imbalance requires a choice between the two.

On balance, the nation would be better off keeping Social Security much as it is today. Despite troublesome demographics, the system can be put on sound financial footing for decades to come with relatively minor changes in tax rates and benefits formulas to correct the currently small imbalance of 2.2 percent. Whether the specific measures advanced by those on the advisory council who would keep Social Security much as it is today are the "right" ones is another issue, but the group is right in stressing that radical revamping is not needed to remedy the system's long-term financial problems.

The System Today

In order to evaluate the alternative approaches, it is important to understand how the system transfers income within and across generations and how benefits are structured. Although Social Security is now building reserves, it is still largely pay-as-you-go, a tax-and-transfer system across generations. The contributions of today's workers are not set aside for their own retirement but are paid out for the benefits of today's retirees. Each generation, in effect, pays for the retirement of its parents.

Benefits are tied to a worker's lifetime earnings, adjusted to reflect average wages prevailing in the economy just before the worker retires; they are not tied, as the common misconception has it, to taxes paid in. Benefits are progressive, providing larger benefits relative to earnings to low-income workers than to high-income workers. And, because of spousal benefits, they favor one-earner couples and couples with widely disparate earnings. Replacement rates (the percentage of preretirement earnings that benefits replace) are now set to be relatively constant across time and across income groups. Over the years the benefits formulas have rewarded virtually all participants; most retirees have received more in benefits than they and their employers paid in (plus a reasonable rate of return). High-income workers have drawn the largest benefits in absolute dollar amount, even though low-income workers have received the largest percentage return.

Option 1: Minor Modifications

The advisory council members who stress that radical revamping is not necessary above all want to maintain the defined-benefits character of the system (hence their adoption of the label "maintenance of benefits" for their plan). They selected proposals from an array of possible actions, all of which carry pluses and minuses, both substantive and political. Among their proposals are adding the 4 million state and local government workers not now covered to increase net payroll tax revenue, making taxing of benefits more general than it is now, and making small reductions in future benefits by calculating lifetime earnings over more years to include more low-earnings years. The maintenance of benefits group also called for consideration of investing system reserves in equities as another means to close the gap between contributions and benefits. Private securities have traditionally yielded higher returns than the Treasuries in which reserves are currently invested.

Among the many other possible options, three in particular have merit: raising the retirement age, reducing benefits to high-income retirees (directly as well as indirectly through the taxation of benefits), and trading off increased survivor benefits against retirement benefits. None of them would alter the system in a fundamental way. They all would resolve the potential clash between the goals of the system in the direction of social adequacy.

The retirement age should be reexamined against a background of ever-rising life expectancy. The normal retirement age of 65, unchanged over the years despite increased longevity, is now slated to rise gradually to 67, but could be indexed to life expectancy thereafter and thus continue to rise. That would maintain the ratio of number of working years to number of retirement years.

Significant economies could accrue from small changes affecting high-income workers (lowering the top end of benefits along with added income taxation of benefits). Such changes would also reduce the redistribution of income from poor workers to well-heeled retirees, a feature of the system that has been widely criticized (Peterson 1996). And they would make the system more progressive in benefits at a time when it cannot possibly subsidize almost all participants as in the past. One thing surely speaks in favor of greater progressivity: decades of growing inequality in the distribution of labor income, an inequality echoed in the personal savings for retirement that people are able to amass during their working years.

The goal of individual equity itself needs to be examined in light of changing conditions. The 50 percent spousal benefit may have made sense in Social Security's early days, but it has led to the anomaly of relatively high pensions for many couples at already high income levels. Survivor benefits, in contrast, are often too low to prevent many elderly (especially the old-old) from slipping below the poverty line when a spouse dies.

While increases in tax rates may be "off the table," several changes should be considered. One would be to return the share of total wages that is covered to a former level; in the past few decades of growing income inequality, the share has slipped from 90 percent to 88 percent. Another would be to include employer-provided health and life insurance benefits in the wage base. Including health care benefits or even including only those above the norm would yield economies in health care that are now blocked by the favorable tax treatment of those benefits--a plus for Medicare even if not for Social Security itself (Cadette 1997).

Option 2: Privatization

The privatization plan outlined by its advocates on the advisory council splits Social Security into two parts: individually managed saving and investment accounts, whose returns to recipients would vary with the individual selection of investments and market performance, and a basic payment (with benefits tied only to number of years at work), which all beneficiaries would receive. For each beneficiary 5 percentage points of the current 12.4 percent Social Security tax rate would be devoted to a personal security account, similiar to a 401(k), which would be open to a wide range of investment vehicles, including equities. The remaining 7.4 percentage points would fund both the basic payment and nonretirement benefits such as disability.

The plan is fraught with problems. Most important, it would weaken--potentially fatally--the system's goal of social adequacy. The theory is that only those unlucky and timid in their investment choices would have to rely on the basic payment for a significant share of retirement income. If they had to do so, however, they would draw benefits considerably smaller than they would under current arrangements. People with the least experience as investors are the most likely to be the "losers," and these people are likely to be low-income workers with little or no prior savings, who also have the most to lose since Social Security is apt to be the major, if not the only, source of their retirement income. A meager guaranteed payment is unavoidable if as much as 5 percentage points of the tax rate is to be freed up for individual investment and if, at the same time, the system is to be brought into overall balance.

It is not just those with losses, moreover, who could wind up disappointed. The equity returns in recent decades of 71/2 percent per year in real terms cannot confidently be extrapolated into the future (Baker 1997). For this rate to hold, economic activity would have to advance more rapidly than the expected trend of 2 percent to 21/2 percent per year; profits would have to mount to implausibly high levels as a share of national income (and wages thus sink to implausibly low levels); or marketwide price-earnings ratios, which are now at record highs, would have to rise still further.

Privatization also involves political risks. The basic payment, which would have the stigma of "welfare" attached to it, would be vulnerable. And pressure to bail out the unlucky (with consequent damage to the long-run financial health of the system) would be intense, especially if there were to be a major downturn in the stock market affecting the retirement planning of large numbers of workers well up in age. There could well come a time, even if years from now, when it would be necessary to reinvent today's system of Social Security to "socialize" once again losses that realistically could not be borne privately.

The alternative of privatization is a poor substitute for the benefit Social Security has offered the nation since the 1930s: a guaranteed base level of income support for virtually all retiring workers, half of whom cannot count on a "private" pension. It would create risks that many--because of low income--should not run. Moreover, by tying retirement benefits to each worker's own investments, privatization would circumscribe the capacity of the system to subsidize benefits to low-income retirees--ironically, at the very time benefits must become more progressive than they were in the past.

A Question of Values

The maintenance of benefits approach, by its very nature, would right Social Security's long-run financial imbalance with minimal dislocation. Privatization would also remedy the problem, but Social Security would be changed, beyond recognition, in the process--a steep price to pay for the relatively high returns many, but surely not all, participants probably would reap as a result. The high returns, moreover, are not all that persuasive, given the opportunity to achieve the same returns by having government itself do the investing. Where the investment risk should be lodged and thus the distribution of those returns is the key issue. That is as much an issue of values as it is of economics.

If, at the end of the day, the choice is to keep Social Security much as it is, additional income tax incentives to promote saving are in order. They would make for faster growth of the capital stock and productivity and thus ease the transfer of income from a relatively small to a relatively large generation. And they are in order from the narrow perspective of Social Security itself. Savings incentives tied to the income tax would help to soften the unpopular measures that will be needed to right the system's long-term financial imbalance. High-income taxpayers would find it easier to accept making the system more progressive if at the same time they were given the opportunity to make larger contributions to 401(k), IRA, and other tax-deferred savings plans. Such a combination would protect the pensions of low- and moderate-income workers, while offering a reduction in taxes that would move the tax system more toward neutrality between saving and consumption (a plus in its own right). Young workers at all income levels would find it easier to accept further slippage in the implicit returns on their Social Security taxes if at the same time they could more easily build a supplementary retirement nest egg. They would be among those to profit most from tax-deferred income, on the axiom that taxes deferred are taxes never paid.

Casting the net wide in other ways is also called for. The Canadian "double-decker" model, in particular, ought to get a sympathetic hearing. General taxation finances a flat payment made to all beneficiaries (which is now means-tested); payroll taxes finance an added payment, which is tied to lifetime earnings. While the particulars that would make sense in the United States may differ, the principle that Social Security's income-support function be financed broadly across the economy, and not by a regressive tax on labor, applies. And so does the principle of financing the individual equity function through earmarked payroll taxes (although it is better to levy them only on employees in order to minimize any distortion in the price of labor).

Building into Social Security benefits formulas a new measure of flexibility--by, for example, linking ongoing as well as initial benefits to prevailing wages--also ought to be considered. Beneficiaries would reap some extra income if productivity were to rise more than expected (an outcome, by the way, they would have helped lay the groundwork for during their working years). If, instead, the economy's performance were to be disappointing, retirees would share in the shortfall (this, too, on the premise that "all are in the same boat"). Because it would be automatic, adjusting pensions to the actual performance of the economy would avoid the troublesome income distribution issues the nation must now confront. It would redress Social Security's inadequacy as a means of reducing poverty among the old-old. It would involve less measurement difficulty than linking benefits to inflation. And it would promote the sense of shared responsibility that is needed for a consensus to emerge on how to adapt Social Security to new circumstances. Other changes to benefits formulas could be made to offset the increased cost; for example, benefits could be lowered early in retirement when personal savings and other sources of retirement income can readily be called on in most cases. Replacement rates are hardly immutable.

Even if existing benefits remain linked to the price level, consideration should be given to shifting the pattern of benefits forward. If Social Security can be made a fair annuity for someone retiring at any age between 62 and 70, it can be made no less fair by skewing the distribution of the same lifetime benefit to the later years. In any case, the high poverty rate of the old-old cautions against arbitrary reduction in cost-of-living escalation based on broad-brush estimates of how much inflation is overstated.

In the debate on Social Security's future, it is important that the nation not lose sight of the underlying problem the coming demographics present: an uncommonly large transfer of real resources from the working to the retired population. This is in the offing by whatever means the baby boom's Social Security benefits are financed, however much the baby boom saves independently for its retirement, and however much the economy grows in the meantime.

This broader perspective counsels not just stepped-up saving and investment, but investment--presumably most of it in the public sector because of the time horizon--that will yield dividends long into the future. Long-lived public capital can do a lot to ease the transfer of resources across generations of markedly different size.

Serious attention also has to be given to reducing the nation's current account deficit. The transfer abroad of command over resources that ever-growing external indebtedness points to cannot but make the transfer of resources across generations of markedly different size all the more difficult.

Note

1. Section 706 of the Social Security Act requires the secretary of health and human services to appoint an advisory council every four years to review the long-run financial outlook of the trust funds under the Social Security umbrella and to make recommendations on how best to prepare the programs for the future. The council's 13 members represented the general public, workers, business, and the self-employed.

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About the Author

Walter M. Cadette is a senior fellow at The Jerome Levy Economics Institute. His areas of special interest include health care, international trade, and regulation of financial institutions. In addition to his work at the Levy Institute, he is chairman of the Holy Cross Health System's investment review committee. Cadette is a retired vice president and senior economist of J.P. Morgan & Co. Incorporated and was editor of and contributor to its publications *Global Data Watch* and *World Financial Markets.* He received an M.A. from Georgetown University and did further graduate work in economics and finance at New York University.

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