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Does Social Security Need Saving?

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Projections of Social Security's future have led many to believe that a financial crisis looms for the system. This is an exaggeration-any problems are far down the road and are hardly important enough to justify the use of the word "crisis." It is correct to caution that something will have to be done to resolve some real and financial problems in providing for future retirees, but this does not necessarily mean that something has to be done today or that it is the Social Security system itself that lies at the heart of these problems.

Almost all commentators have focused on the *financing* of Social Security and thus have proposed *financial* solutions. We argue that questions about the future of Social Security pertain to the size and the distribution of the real economic pie. Once this is recognized, it becomes obvious that none of the popular reforms, such as privatization, reduction of current benefits, or "locking away" budget surpluses, can really help. We need to formulate alternative policy recommendations that are consistent with the true scope and nature of the future problem.

Each year the trustees of the Social Security Trust Funds (Old-Age and Survivors' Insurance Fund and Disability Insurance Fund, or OASDI) provide a statement of the financial status for the previous year and short-range and long-range projections intended to capture the effects of demographic shifts in working and retiring cohorts. Because the trustees recognize the difficulties inherent in making projections over a long time span, they make three sets of projections: high cost, intermediate cost, and low cost.

According to the trustees' low-cost projection in 1999, the estimated income rate (revenue from payroll taxes expressed as a percentage of taxable payroll) will exceed the estimated cost rate (payments to beneficiaries expressed as a percentage of taxable payroll) over the next 25-year, 50-year, and 75-year periods. The intermediate-cost projection results in a positive balance over the 25-year period only and a shortfall of income of 2.07 percent of taxable payroll over the 75-year period. The high-cost projection shows a 0.47 percent shortfall for the 25-year period and 4.97 for the 75-year period. What these estimates indicate is that, if payroll taxes were immediately increased by 2.07 percentage points in the intermediate-cost case or by 4.97 percentage points in the high-cost case, OASDI would be in positive balance for 75 years into the future.

Payroll tax rates should be reduced over the next few years and then increased as required in the future. This would allow today's workers to retain more income, but would not in any way reduce the nation's ability to care for tomorrow's retirees.

The projections of long-range shortfalls arise from pessimistic assumptions of low fertility rates, slow growth of the labor force and its productivity, increased longevity, low net immigration, low growth of real wages, and a falling portion of wages that are taxable, with the low growth in the labor force and real wages being the most significant. The trustees are assuming that these economic and demographic variables will be far worse that anything experienced in the past. However, if just a few of the important variables return to long-run trends, the gap between income and outgo would be closed without resorting to higher payroll taxes or reduced benefit payments. For example, if, instead of falling to 0.9 percent, the rate of real wage growth were to rise to 2.0 percent (compared to the 2.2 percent that prevailed throughout the 1960s); if an extra 600,000 immigrants were to be added each year; and if, instead of falling to 1.9, fertility rates were to rise to 2.2 from their current 2.03 (which is low relative to long-term statistics), 89 percent of the intermediate-case financing gap would be eliminated.

Even if the trustees' assumptions are correct, their projected financial gap does not qualify as a crisis. On intermediate-cost assumptions, OASDI income (excluding interest) is currently just above 5 percent of GDP, outgo is just above 4.5 percent of GDP, and the balance is 0.79 percent of GDP. In 2014 that income will just cover outgo, by 2030 outgo will exceed income by about 1.8 percent of GDP, and by 2075 the shortfall will rise to just over 2 percent of GDP. The problem could thus be resolved by increasing the share of GDP devoted to OASDI by about 2 percent after 2030, and increases of that size have occurred in the past with little economic disruption.

Setting aside considerations of the financial gap, we can examine the "coming crisis" from another vantage point: the burden to be borne by future workers to support retirees. Given assumptions about rising longevity and lower fertility rates, while we now have just over 3.3 workers per OASDI beneficiary, we will have fewer than 1.8 by 2075. The rise in the ratio of beneficiaries to workers makes it appear that the burden on future workers will increase by almost a factor of two. However, if we add the under age 20 population to the 65 and over population to obtain a "dependent" population (people not of normal working age), we find that workers in 1965 supported more dependents than any generation will through the year 2075. Although it is true that the number of people 65 and over will rise relative to the number of workers, the combination of lower birth rates and more women in the labor force will reduce the burden of supporting those under age 20 by more than enough to offset the growing burden of supporting the aged.

We can also look at the "real" burden of providing the goods and services that will be needed by retirees. In 1910 the number of farmers needed to produce the food consumed by 100 Americans was 15, but that number had fallen to 1 by 1990. The number of manufacturing workers needed to produce the manufactured goods consumed by 100 Americans had fallen from 13 in the mid 1940s to 7 by 1990. Worker productivity has doubled or more than tripled in some sectors over the past 50 years. If it doubles over the next 50 years, there will be no problem in producing the basket of goods and services that will be required by all consumers, including the rising numbers of retirees.

There also does not appear to be any looming crisis in making the goods and services available to workers and nonworkers. The trustees' intermediate projections show that the real wages of workers will increase by 75 percent over the next half-century. Even if tax rates would have to rise to cover the expected OASDI financial gap, tomorrow's workers would still have higher standards of living than they have today. After moving a greater share of total GDP to OASDI recipients, workers will be left with a larger basket of goods and services than they consume today-even on what might be overly pessimistic assumptions about real growth rates.

Whether we assume that there is no looming crisis or that the future will unfold more or less as the trustees have projected, it is still appropriate, even necessary, to think in long-range terms. Can we, or should we, do anything today to ensure that the elderly will be cared for tomorrow? Is it possible for society to do anything today to increase the quantity of goods and services that can be produced tomorrow for consumption not only by retirees but also by workers and nonretirees who do not work?

If the quantity of goods and services is not increased, society may well want to change the amount of goods and services distributed to the elderly as their numbers rise relative to the number of younger Americans. The thinking behind much of the debate over Social Security seems to center on the fear that if we do not increase financial saving, funds will be inadequate to finance a sufficient share going to the elderly to meet their needs. However, if this is what the debate is really about, most of the solutions proposed thus far have at best an uncertain probability of succeeding. This is because they center on accumulating financial reserves in the next few years-by some combination of reduced benefits and increased tax rates and by increasing the reserves' growth rate, for example, by "investing" them in the stock market to obtain higher returns than those expected from government bonds. It is supposed that the larger reserves will postpone the "day of reckoning" since their interest earnings will supplement payroll tax receipts and assets can be sold when total revenues fall short of expenditures. However, accumulation of reserves, by itself, does nothing to guarantee that more of society's output will be shifted to beneficiaries in the future.

Some argue that Social Security ought to run a surplus now to avoid general budget problems later. It is important to remember that the Trust Funds consist of nonmarketable Treasury debt. If the Treasury wants to convert this debt into cash, it will have to either issue new debt or generate new tax revenue in excess of what will be required for other government spending. But this is exactly what would be required even if there were no Trust Funds at all.

Unless accumulation of the Trust Funds actually enhances society's ability to produce goods and services in the year 2013 or 2021 or 2034, the output to be distributed will be exactly the same whether the Trust Funds are larger or smaller. At the very least, the argument for accumulation of a trust fund as a means of increasing society's ability to provide for the needs of OASDI 35 years into the future rests on shaky theoretical grounds. If this argument is rejected, then the proposed reforms boil down to schemes that would merely attempt to shift the distribution to retirees. But if this shift is all that reformers intend, using the tax system is much more certain to shift distribution of GDP. In the year 2013 or 2021 or 2034, if it is decided that the elderly should get a larger share of output, then taxes could be increased (reducing disposable income of workers) and benefit payments to the elderly could be increased. It is far more direct and preferable to raise payroll taxes in any given year when a shift is necessary than to raise them today in an attempt to accumulate financial assets to be sold later in the hope that this might indirectly affect distribution.

Although it makes little economic sense to accumulate OASDI Trust Funds to provide for retirees, it does make sense to consider how to enhance the economy's ability to produce. Some proponents of Social Security reform have argued that changes made in the system today to accumulate a trust fund surplus can affect supply and demand constraints on growth. But whether or not any of their arguments are valid, it is not at all clear that this should be the responsibility of Social Security. OASDI is not a broad-based program; the taxable OASDI base is far less than half of national income. If a government surplus can be used to stimulate growth, this would be more properly undertaken as a general fiscal policy. First, a general fiscal policy would be much more effective because it can use the entire federal tax system, not just the smaller OASDI tax base, allowing a faster growth rate to be achieved (if, indeed, higher taxes can stimulate growth!). Second, since any growth achieved would be beneficial across society, it is equitable that all individuals share the cost (higher taxes), rather than only those on OASDI-covered payrolls. Similarly, if it is decided that government should attempt to stimulate growth by direct investment in the stock market, this would be better accomplished as a general fiscal policy. Policies to increase human capital or to encourage resource mobility or to finance research and development are all better left to general government revenues and spending than to OASDI revenues and expenditures. An objection might be that Congress and the president do not have the political will to undertake such measures, but it makes little sense to reform Social Security in an attempt to accomplish what our elected representatives should, but will not, do.

Policy Recommendations

Our analysis leads us to conclude that the OASDI portion of Social Security does not face a financial crisis. We believe that the trustees have been overly cautious in their intermediate long-range forecast, but even on the basis of their assumptions we find no reason to suppose that a financial crisis looms in the future. There is also no crisis regarding the burden on future workers of providing the real goods and

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services that will be required by the elderly. Further, we see no compelling argument that changes in OASDI policy made today could ameliorate any problems that might be encountered long into the future. It is probable that tax rates will have to be increased in the future, perhaps even before 2020, but the increases will be relatively small. After 2030, perhaps 2 percent more of GDP will have to be devoted to the OASDI beneficiaries than is now devoted. While not insignificant, this is surely feasible without causing an undue burden on future workers. Thus, we are encouraged to make the following recommendations.

1. *OASDI should gradually be returned to a pay-as-you-go system.* We find no reason to suppose that accumulating large balances in the Trust Funds is a proper way to provide for future retirees. Thus, payroll tax rates should be reduced over the next few years and then increased as required in the future. This would allow today's workers to retain more income, but would not in any way reduce the nation's ability to care for tomorrow's retirees.
2. *Discussion should begin about the proper tax base to use to generate revenue for OASDI.* Given demographic changes, which will reduce the working population relative to OASDI beneficiaries, a broader base is preferred. This is particularly important given that covered payroll is expected to fall significantly relative to GDP. Discussion should include the possible elimination of the contribution base or at least of adjustments to this base to ensure that a constant percent of payroll falls below the base. Inclusion of fringe benefits in the taxable base might also be pursued.
3. *The Trust Funds should be capped at no more than 100 percent of expenditures, an amount generally thought to be sufficient to see the programs through back-to-back recessions.* We would actually prefer to cap the Trust Funds at a much lower figure, since a reserve of 8 to 9 percent is sufficient to meet liquidity needs and funding from the general budget could be provided in severe recessions as necessary. Because the Trust Funds are already well over 200 percent of expenditures, this means that deficits can be run over the next several years until the funds fall to 100 percent of annual spending.
4. *General fiscal policy should be biased to encourage faster growth, greater employment, and higher labor force participation.* For example, as the nation moves to negative natural population growth, we may wish to increase significantly the numbers of legal immigrants to ensure a growing labor force. Or, we may wish to increase substantially public investment in human capital and infrastructure to increase productive capacity. Such initiatives are in the realm of general fiscal policy and clearly lie outside the role and function of the Social Security system, but while benefiting the whole society, they would also increase the financial and real outlook for OASDI.
5. *The trustees should abandon the use of long-range forecasts of actuarial balance.* Attempting to make such forecasts results from a flawed understanding of the way in which society provides future benefits. The trustees should report actuarial balance for no more than a five-year period. For the long-range, it is sufficient to report projections of annual program income, outgo, and balance.
6. *Major changes, such as partial or complete privatization, reduction of benefits, and extension of retirement age, have no place in the reform of OASDI programs.* These, too, result from a flawed view of the operation of the programs and the extent and nature of a Social Security "crisis."

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