

THE CENTURY FOUNDATION

Issue Brief

FIXING SOCIAL SECURITY

CHANGES DO NEED TO BE MADE, BUT THE CHOICES AREN'T HARD NOR THE MEASURES PAINFUL

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Updated with a new analysis of the President's Social Security proposal.

Creating a "Crisis"

President George W. Bush has said that the administration's first task in the Social Security reform debate is to demonstrate to the American people that Social Security has a big financial problem—a crisis requiring action now. In trying to make this case, those speaking for the administration have done everything they can think of to make the long-range shortfall in Social Security seem as big as possible. They have greatly exaggerated the problem in three different ways.

The first is to present the drop in the workers-to-beneficiary ratio as very large and unplanned for. They point out that in 1950 there were 16 workers paying into the system for each beneficiary taking out, and that the ratio has gone way down so that now the ratio is only 3.3 workers to each beneficiary and in the long run it will be only 2 to 1 or even 1.9 to 1. They ignore the fact that in 1950 only about 15 percent of the elderly were eligible for benefits and that it was expected by all who were acquainted with the program that the ratio would, of course, change dramatically as a greater proportion of the elderly became beneficiaries.

Instead, the impression is left that the program was sound only when 16 paid in for every one taking out. Thus, of course, when the ratio changed to 3.3 to 1, the program became "unsustainable." What in fact happened is that when just about all the elderly first became eligible for Social Security benefits, about 1975, the ratio was 3.3 contributors to each beneficiary and the ratio has stayed that way for the past 30 years. As the baby boom reaches retirement age, as the administration says, the ratio is expected to drop for the long run to 2.0 or 1.9 workers to each retiree. But that is the size of the problem—a drop from 3.3 to 2 workers per retiree. The much used 16 to 1 figure is simply a reflection of the immaturity of the system back in 1950 when very few of the elderly had worked under the program long enough to be eligible for benefits.

The second way they make the shortfall seem as big as possible is to use dollar figures instead of percentage of payroll figures and make estimates for an "infinite horizon." Instead of emphasizing that the shortfall over seventy-five years is 1.92 percent of payroll, which can obviously be

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eliminated by any combination of income increases or benefit reductions that are equivalent to a 1 percent increase in the contribution rate for employees and employers each, administration representatives talk about a present value shortfall of \$11.1 trillion figured over an infinite horizon, adding up shortfalls decade after decade for hundreds of years after the program's financing could quite easily have been fixed. An infinite horizon of \$11.1 trillion sounds daunting indeed! But it is not pointed out that estimates using the infinite horizon approach would show a gross domestic product so huge that the total future shortfall in Social Security would weigh in at only about 1.2 percent of the whole.

Finally, they greatly exaggerate the consequences if nothing changes and the trust funds have to cash in all their bonds by 2041. Of course, this is inconceivable. With 48 million beneficiaries today and well over twice that many seventy-five years from now, Congress will make needed changes long before the trust funds are exhausted. But just suppose it doesn't. Under these circumstances, according to the estimates the administration relies on (the middle-range projections of the Social Security Board of Trustees developed by the professional actuaries of the Social Security Administration), the program still would be able to pay higher real benefits to those retiring in 2041 than the benefits being paid to those retiring today. That is, Social Security would be able to pay full benefits on time as prescribed by law—just as it has for the past seventy years—until 2041, and then still would be able to pay higher benefits to those retiring at that time, including adjustment for inflation, than are being paid to those retiring now. And the program would be able to continue making such inflation-proof payments indefinitely into the future. This can hardly be described properly as being “bankrupt” or “flat broke” in 2041, as administration spokesmen have been saying.

What does happen in 2041 (if no changes are made in the program between now and then) is that the system would no longer be able to pay benefits that fully reflect the increases in wages occurring during a beneficiary's working career. Present law does provide for this and it is extremely important that adequate financing for this provision be maintained. The only true measure of the effectiveness of a retirement system is the extent to which it replaces what the worker has been earning in the years before retirement. It is, therefore, of great importance to fully finance present law benefits. Yet, with sufficient funds after 2041 to pay benefits higher in purchasing power than those now being paid, Social Security cannot be correctly labeled as “flat broke” or “bankrupt” from 2041 on.

A Relatively Painless Solution

Fortunately, there are several ways to bring the system into balance and pay benefits that are kept up-to-date with wages, changes that are desirable in any event and that I would favor whether or not there was a long-run shortage of funds. *It is not true that hard choices have to be made and painful measures taken to restore balance to long-range Social Security financing. Changes do need to be made but the choices are not hard nor the measures painful.* There is very little downside to what I propose:

- 1. Gradually raise the cap on earnings covered by Social Security so that once again 90 percent of all such earnings would be taxed and counted for benefits.** Ninety percent was the number set by the Congress in 1981, the last time it considered this issue. But Social Security taxes are now being applied to only about 85 percent of earnings in covered employment because over the past twenty years or so wages at higher levels have risen faster than those at lower levels. Thus, without any decision to change the policy and simply as a byproduct of wages rising faster for the higher paid than for the lower paid, 15 percent rather than 10 percent of covered earnings have now risen above the maximum and

are escaping Social Security taxation. This is a major reason for the long-run shortfall that is now predicted.

I favor returning to the 1981 goal of 90 percent very gradually. A sudden major jump in the cap would be much too hard on those earning between the present \$90,000 cap and another \$50,000 or so. I would favor increasing the cap by only an additional 2 percent each year starting in 2006. Under this plan, we would reach the 90 percent goal in about 2043. (Very little additional is saved if the change is implemented more quickly, say twice as fast.) The phase-in, of course, would affect only the 6 percent of workers now earning more than today's maximum.

Under present law, the maximum goes up automatically each year by the same percentage as the nationwide increase in average wages. This proposal would increase the maximum by an additional 2 percent. For example, if next year average wages went up 3 percent, the increase in the maximum would be 5 percent, and thus would rise from \$90,000 to \$94,500. For the 6 percent of workers affected, payroll deductions at the same rate they have been paying would go on longer in the year—an additional week at the most—until the new cap on wages is reached.

The worker would realize higher benefits for these additional contributions, although not enough higher to use up the additional contributions. A return to 90 percent is not a new policy but a return to an old policy adopted by Congress nearly twenty-four years ago. This change alone would reduce the projected deficit of 1.89 percent of payroll in the 2004 Trustees report by 0.61 percent of payroll.*

2. Beginning in 2010, change the estate tax into a dedicated Social Security tax.

Present law gradually reduces the estate tax so that by 2009, only estates above \$3.5 million (\$7 million per couple) will be taxed. The administration then wants to abolish the estate tax completely in 2010. Instead, I would freeze the tax at the 2009 provisions and dedicate the proceeds to Social Security from 2010 on. This new source of Social Security income would be treated as a dedicated tax just like the tax on employers' payrolls and rationalized as paying part of the cost of getting the system started.

When Social Security began, benefits for those nearing retirement age were much higher than could have been paid for by the contributions of those workers and their employers. This was done so that the program could begin paying meaningful benefits even though workers nearing retirement would have only a short time to contribute.

Arrangements for paying off at least part of this deficit of contribution of the first generations covered by the program ought to be put in the law now and not left to future generations to deal with entirely on their own. An estate tax is a highly progressive way of meeting this cost, and dedicating it to Social Security would strengthen the contributory

* The estimates used throughout this discussion of these proposals are those of the Office of the Actuary, Social Security Administration. They are based on the 2004 Trustees Report. It will take time to shift to using the 2005 report and the differences will be very small, for example, a 1.92 percent of payroll deficit in 2005 instead of 1.89 in 2004. Consequently, the Social Security actuaries will be working from the 2004 report for some time.

nature of the program by bringing the earmarked contributions of workers closer to the value of their own benefits.

Withholding benefits from any contributing workers on the grounds that they were too wealthy to need benefits would change the nature of the program and, in my judgment, be very unwise. On the other hand, it seems desirable for wealthy families to pay more into Social Security relative to what they take out than they do now, providing it can be accomplished without weakening the contributory principle. This proposal accomplishes that goal. Moreover, to have huge estates transferred from one generation to another without even a tax paid to the common good is undemocratic in principle. A \$3.5 million exemption would seem to be more than sufficient protection against the tax breaking up small family farms or businesses. The change would reduce the deficit by about 0.51 percent of payroll.

These two changes alone (counting interactions between them) would bring the deficit over seventy-five years to 0.79 percent of payroll, the very edge of “close actuarial balance.” “Close actuarial balance” is a test that the trustees have used over the years to determine whether or not it was important to make changes in the financing of the program. The trustees have realized, of course, that it is impossible to make exact estimates over a period as long as seventy-five years, so they introduced this test to define a reasonable leeway. They have set this test as “income within plus or minus 5 percent of program costs over seventy-five years,” the usual estimating period. The cost of the program today is estimated to be 15.73 percent of payroll, so a deficit of 0.79 percent of payroll fits the trustees’ definition of close actuarial balance.

But claiming close actuarial balance at a deficit of 0.79 percent of payroll would put too much emphasis on a rule of thumb. I believe that we should include my third proposal for this test which brings the deficit well within close actuarial balance.

3. Improve the return on Social Security funds by investing part of them in equities, as just about all other public and private pension plans do, including investment by the Federal Railroad Retirement Board, as specifically authorized by Congress.

Certain other government retirement systems such as the one for employees of the Federal Reserve Board, the one for employees of the TVA, and the Canadian Social Security system, also invest directly in stocks.

Under the approach I recommend, up to 20 percent of total accumulated Social Security funds eventually would be invested in a broad indexed equities fund, phased in between 2006 and 2025. A Federal Reserve-type board with long and staggered terms would have the limited functions of selecting the index fund and selecting the portfolio managers by bid from among experienced managers of private indexed funds.

Social Security would not be allowed to vote any stock or in any other way influence the policies or practices of any company or industry whose stock is held by the indexed fund. (There is no more reason to expect government interference in the operation of equity markets under this plan than under the president’s proposal giving government the responsibility for the investment of the recommended individual accounts. The argument against Social Security investing in stocks based on the potential for “market interference,” therefore, has recently been muted.)

The plan would be to invest 1 percent of Social Security assets in stock at the end of 2006, 2 percent at the end of 2007, and so on up to 20 percent for 2025 and later, but with a limit on assets invested in stocks of 15 percent of the total market value of all stocks.

Investment in stocks is very risky for the individual because, among other reasons, he or she will ordinarily need the money upon retirement, and at that time stock prices may be in a slump. As Gary Burtless of the Brookings Institution has shown, variations of only a few months or years in the time of filing can make very large differences in the value of lifetime annuities. In contrast, collective investment by the Social Security fund is largely protected against this risk, since under an adequately financed Social Security program, there would never be a liquidation of assets requiring a sell-off of the equity holdings. Thus the Social Security fund would be able to ride out the market's ups and downs. As with the investments of a private retirement plan, the idea would be to build up and hold on to a reserve whose earnings would help meet future costs. This proposal is estimated to save 0.37 percent of payroll.

With these three changes, and taking into account interaction among them, the long-range deficit of the program would be brought down from 1.89 percent of payroll (based on the 2004 trustees' projections) to 0.41 percent, well within the traditional test of "close actuarial balance." and leaving a slightly lower deficit than the approximately 0.50 percent of payroll deficit left by the Bush proposal to greatly reduce future benefits for all but the poor. Unlike the President's proposal to cut-and-privatize, my plan would get well within close actuarial balance without any benefit cuts and without any tax rate increases.

Alternate and Additional Proposals

In recent years, the concept of close actuarial balance has received little attention. Emphasis has been put on reaching full balance, and in this administration there has been a shift to judging the adequacy of financing by going beyond a seventy-five-year period and emphasizing a concept called "sustainable solvency." Sustainable solvency requires not only balance at the end of seventy-five years, but stable or rising trust funds at that point, which implies adequate financing for a very long period, perhaps hundreds of years beyond the traditional seventy-five years. And there is now even an attempt by some to establish the standard for financing as sufficient for an "infinite horizon." This latter goal could force attempts to achieve an unreasonable and undesirable trust fund build-up of gigantic size, which still might not be adequate to meet unknowable conditions hundreds of years from now.

To get to full balance over seventy-five years if policy makers are not satisfied with the goal of close actuarial balance, I would recommend two additional changes:

4. Adopt the more accurate consumer price index (CPI) recently developed by the Bureau of Labor Statistics (the so-called chained index) to better account for changes in buying habits as prices go up. The Social Security cost of living adjustments (COLA) would rise somewhat more slowly using this more accurate CPI and consequently the cost of the system would be reduced by about 0.35 percent of payroll.

This is the only benefit reduction that I think should be considered, and that only in the interest of accuracy. Benefits are not too high. They seem to me barely adequate, and they are currently being reduced further because of the 1983 legislation raising the first age at which full benefits are payable from age 65 to age 67. Moreover, every time the Medicare premium is increased, the Social Security benefit is reduced to pay for it, and there is less

money to cover the cost of food, clothing, and shelter as Social Security benefits have been designed to do.

5. Beginning in 2010, cover all new state and local employees under Social Security except for some temporary workers such as election officials. About three-fourths of state and local government employees are already covered, but all regular employees should be. Allowing five years or so for states and localities to redesign their retirement systems as supplements to Social Security should provide time enough for collective bargaining and an outcome satisfactory to the parties so engaged, and for the government entities involved to budget for their share of contributions.

With this extension of coverage, just about everyone who works would be under Social Security, sharing both the benefits and obligations of our national family protection system. Making the system universal in this way would reduce the deficit by about 0.19 percent of payroll.

With these five changes—all desirable in their own right—full seventy-five-year balance would be restored with a small plus margin of 0.05 percent of payroll.

It is recognized, however, that over a seventy-five-year period the assumptions underlying the estimates would change from time to time, causing the estimated cost of the system to either rise or fall. To make sure that the trust funds would be maintained and that the need to sell off stocks and bonds could be avoided, policymakers might want to deliberately over-finance the cost of the benefits, as estimated for the next seventy-five years. An easy way to do this would be to schedule a small contribution rate increase, say 0.50 percent of payroll for employers and employees each, at the point where the ratio of the trust funds at the beginning of the year to the benefits payable in the following year starts to fall—estimated to be 2023 after the adoption of the first five changes recommended in this memorandum.

In the years ahead, this rate can be pushed back, moved up, or changed in amount, depending on future changes in the assumptions underlying the long-range cost estimates. It becomes a kind of “balancing rate” providing for the continuing adequacy of long-range financing as the assumptions underlying the long-range estimates change.

With this rate added (and without assuming any future changes in it), it is estimated that the system is adequately financed for many decades beyond the traditional period of seventy-five years. Given all the unknowns involved in estimating for so long a period, going even further to a test of “sustainable solvency,” or certainly to an “infinite horizon test” seems excessive. No other program at home or abroad is held to a standard of an estimate for pre-financing for even as long as seventy-five years. Imagine applying such a standard to defense spending, or road building, say!

The President’s Proposal to Cut-and-Privatize—Mixed Wage and Price Indexing

In his April 28 news conference, the president at last made clear the level of Social Security benefit cuts he has in mind and the philosophical direction of his thinking. He is backing Robert Pozen’s plan, which would gradually cut most benefits to the same level as benefits for those now earning at the thirtieth percentile of today’s wage distribution (about \$20,000) and which fundamentally would change the nature and goals of Social Security. For seventy years, Social Security has followed the Roosevelt design of a contributory, wage-related system with the retirement benefits designed to

partially make up for the loss of past earnings. A major characteristic of such a plan is its universal usefulness, and the proper measure of its success is the extent to which benefits replace the earnings in the years before retirement.

Social Security is our most successful antipoverty program, by far, having reduced poverty among the elderly from about 35 percent in 1960 to about 9 percent today, roughly the same as for other adults. Without Social Security, nearly half of all retirees would be poor. But Social Security is much more than an antipoverty program. It is the base on which all American families build protection against income loss because of old age, disability, or the death of a family breadwinner. It is income insurance. Two-thirds of Social Security retiree beneficiaries rely on Social Security for most of their income. The president now is proposing a fundamental change that gradually would drop the benefit variation by past earnings for most retirees and move to a plan with the welfare objective of being useful mainly for the poor and increasingly of less and less importance to the nonpoor.

This change in objective and philosophy would be carried out by retaining current law benefits for the poor (not improving them, just keeping them as they are), and cutting promised benefits with increasing severity for the 70 percent of workers with wages above the very lowest paid. Ultimately, most retiring workers would get the same low benefit as would be paid to those now earning about \$20,000. Even though a flat benefit system, it would continue to be financed by deductions from workers' earnings, with the deductions rising with increasing earnings. The more one has paid in, the larger the benefit cuts. It is hard to see just who would support such a change if the effects are fully understood. If ever adopted, such a program would soon lose the political support of average and above-average earners and thus gradually its financial support.

As computed by Jason Furman for the Center for Budget and Policy Priorities, an average earner would receive a reduction in Social Security benefits of \$3,523 a year (in today's dollars, adjusted for inflation) upon retirement in 2045. That's 16 percent lower than would be the case under current law. An average worker retiring in 2075 would receive \$7,629 less—a 28 percent reduction.

Workers who earn more than the average would face even deeper Social Security reductions. Someone who earns 60 percent above the average wage—about \$58,000 today—would face a 25 percent cut upon retirement in 2045 and a 42 percent reduction in 2075.

Privatized Individual Savings Accounts

The other part of the president's proposal that he has been promoting across the country is the partial privatization of Social Security; that is, diverting to private accounts up to four percentage points of the 6.2 percent of earnings now paid by employees for Social Security protection. The administration spokespersons now admit that such privatization does nothing to meet Social Security's long-term shortfall. In fact, it would make it harder to fix Social Security by taking money away.

A supplemental private saving plan on top of Social Security is a good idea, but a plan carved out of Social Security, putting basic benefits at risk is not a good idea. For the long run, the net result of the mixed price-and-wage indexing plan is a flat low benefit for everyone now earning above about \$20,000 a year. Adding a subsidized private account would produce still lower Social Security benefits and a risky private supplement for the higher paid with the amount of the supplement depending on the ups and downs of the stock market, with some winners but also many losers.

Conclusion

The president claims that Social Security is outdated and should be radically altered. I disagree. The basic need for Social Security has not changed and will not change as long as people continue to be primarily dependent on wages for their support. In a wage economy the need for social insurance is universal and unending; people pay into the system while working, and when they are old or disabled, or when a working family member dies, benefits are paid out of the accumulated funds to partly replace the wages lost.

Some conservatives have also claimed that Social Security, as originally intended by Roosevelt, was limited to preventing poverty among the elderly. This modest objective, they say, was reasonable, but Social Security has been expanded way beyond this goal so that it is now out of control. These people are wrong on the facts.

Roosevelt, in 1931, while governor of New York, in his annual message to the legislature, defined the goals of social insurance (in other words, Social Security) as follows:

Our American aged do not want charity, but rather old age comforts to which they are rightfully entitled by their own thrift and foresight in the form of insurance . . . the next step to be taken should be based on the theory of insurance by a system of contribution commencing at an early age. In this way men and women will, in arriving at a period when work is no longer practicable, be assured not merely of a roof overhead and enough food to keep body and soul together, but also enough income to maintain life during the balance of their days in accordance with the American standard of living.

Far from limiting the program to the goal of preventing poverty, Roosevelt in this quotation apparently had in mind keeping benefits up to date with rising earnings after they are first awarded, a more liberal standard than present law which bases the initial benefit on indexing to wages, but from then on raises benefits in accordance to prices.

There is no reason to cut Social Security benefits under a slogan of “reform.” “Reform” is not needed. Social Security has not failed. What is needed are some relatively small changes that are desirable in any event and that would improve the fairness and efficiency of Social Security, while at the same time improving the program’s financing. Diverting Social Security funds into private accounts as proposed by the president only makes basic retirement benefits uncertain and the program more difficult to finance. And the president’s attempt to turn the universally useful Social Security system into a poor-person’s program should be firmly rejected.

This brief should not be construed as reflecting the views of The Century Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Bringing Social Security into Long-Range Balance

	<i>Percent of payroll</i>
<i>Starting point: The seventy-five-year deficit as projected by the trustees' 2004 middle-range estimate:</i>	+ 1.89
<i>Deficit-reduction steps:</i>	
1. Gradually restore the maximum taxable earnings base to 90 percent of covered earnings, the level set by Congress in 1981.	- 0.61
2. Change the estate tax into a dedicated Social Security tax, effective in 2010, following the 2009 provisions in present law, which taxes only estates of more than \$3.5 million (\$7 million for couples) at a rate of 45 percent.	- 0.51
<i>Subtotal for 1 and 2</i>	- 1.12
<i>Deficit at edge of close actuarial balance (below 0.79 percent of payroll)</i>	- 0.79
3. Invest some of the assets of the trust funds in stocks, reaching 1 percent of assets at the end of 2006, 2 percent at the end of 2007, and up to 20 percent for 2025 and later, but limit assets to 15 percent of the total market value of all domestic stocks.	- 0.37
<i>Subtotal for 1 through 3</i>	- 1.47
<i>Deficit well within close actuarial balance</i>	- 0.41
4. Improve the accuracy of the cost of living adjustment (COLA) by using the Bureau of Labor Statistics' most recently developed consumer price index, the "chained" index, which better accounts for changes in buying habits as prices rise.	- 0.35
5. Make the program universal; cover all regular state and local government employees after 2009.	- 0.19
<i>Total reductions 1–5 (taking interactions of the above proposals into account)</i>	- 1.94
<i>Seventy-five-year balance</i>	+ 0.05
6. Increase contribution rates on employees and employers by 0.5 percent each in 2023, when otherwise the ratio of the trust funds at the beginning of a year to the benefits in the following year starts to decline.	+ 0.60
<i>Program kept in balance for many decades beyond the traditional seventy-five years</i>	+ 0.65

Source: The estimates in this table have been made by the Office of the Actuary, Social Security Administration, based on the assumptions underlying the middle-range estimates of the 2004 Trustees Report.