Policy Brief

Stanford Institute for Economic Policy Research

Straight Talk on Social Security Reform

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It [Social Security] cannot remain static. Changes in our population, in our working habits, and in our standard of living require constant revision.

— President John F. Kennedy, June 30, 1961

Introduction

It is worth recalling the original mission of Social Security. Enacted in 1935, at a time when the unemployment rate exceeded 20 percent, the primary purpose of Social Security was to provide protection against poverty-ridden old age. An important corollary was to provide the wherewithal for older workers to leave the labor force to open up jobs for younger workers in the severe long-lived Great Depression. Paid out as inflation-adjusted annuities, and providing benefits to survivors and the disabled, Social Security provides not only income to retirees but several types of insurance that, at least historically, were not readily available on an actuarially fair basis in private markets.

The Social Security system is America's largest, and in many ways most successful, social program. Approximately 138 million Americans pay payroll taxes to support retirement, survivors, disability, and Medicare hospital insurance benefits. About 48 million Americans receive retirement, survivors, or disability benefits, and about 41 million are enrolled in Medicare. About one-third of current elderly retirees have little other income besides Social Security benefits; for another one-third, Social Security is nontrivial; and for the top one-third, Social Security is a small part of their retirement income.

Social Security also has been significantly responsible for one of the greatest achievements of our society: the tremendous decrease of poverty among the elderly. Thus, it is important to maintain a strong defined-benefit core of Social Security.

However, the taxes, benefits, and various structural provisions of Social Security and Medicare distort individual behavior in myriad ways: retirement decisions, saving behavior, labor supply, medical outlays and their composition. So, to some extent, Social Security crowds out earnings and private savings and thus the actual level of benefits somewhat overstates the net contribution of Social Security to elderly income. Aggregate expenditures by the federal government on Social Security and Medicare totaled $744 billion, or 6.4 percent of GDP in FY2004 and are projected to grow to $1.1 trillion by 2010, or 7.1 percent of GDP, substantially more than double projected national defense outlays. On their current automatic pilot growth paths, Social Security and Medicare will account for an ever-larger fraction of the budget

May 2005

and the GDP. Either taxes will have to be raised substantially, which risks economic disruption or stagnation, other programs will be squeezed to a fraction of their current size, or the systems will have to be reformed.

Figure 1 presents Social Security outlays and receipts, both historical and projected. Outlays start to exceed revenue by 2017 and the so-called trust fund is exhausted by 2041.

Since President Kennedy made the remark above, the poverty rate among the elderly has fallen by two-thirds to below that of the non-elderly (see Figure 2). At the same time, the payroll taxes that finance Social Security and Medicare have doubled as a share of the budget, and Social Security and Medicare (which did not exist in 1960) outlays have almost tripled as a share of the much larger budget.

Looking to the future, the life expectancy of the elderly is projected to rise another four years in coming decades, the aged-dependency ratio is projected to more than double in this period (Figure 3), and the Social Security system faces a long-term projected shortfall of roughly $11 trillion in present value if — and it is an extreme and unlikely "if" — the current benefit formula were carried forward into the indefinite future.

Some argue that these projected benefit increases are easily affordable, requiring "only" a permanent and immediate 2 percentage points of GDP tax increase. For perspective, this is larger than the temporary Reagan and Bush defense buildups. It assumes such a large tax increase would not damage the economy and, even more implausibly, could build a large surplus that would neither be spent on other programs nor affect future benefits. If put off until Social Security is running deficits, the tax increases would have to be much larger, an increase in payroll tax rates of 50 percent by 2040. The ability of the economy to generate strong economic growth is likely to be severely impaired without serious sensible Social Security and Medicare outlay reform now.

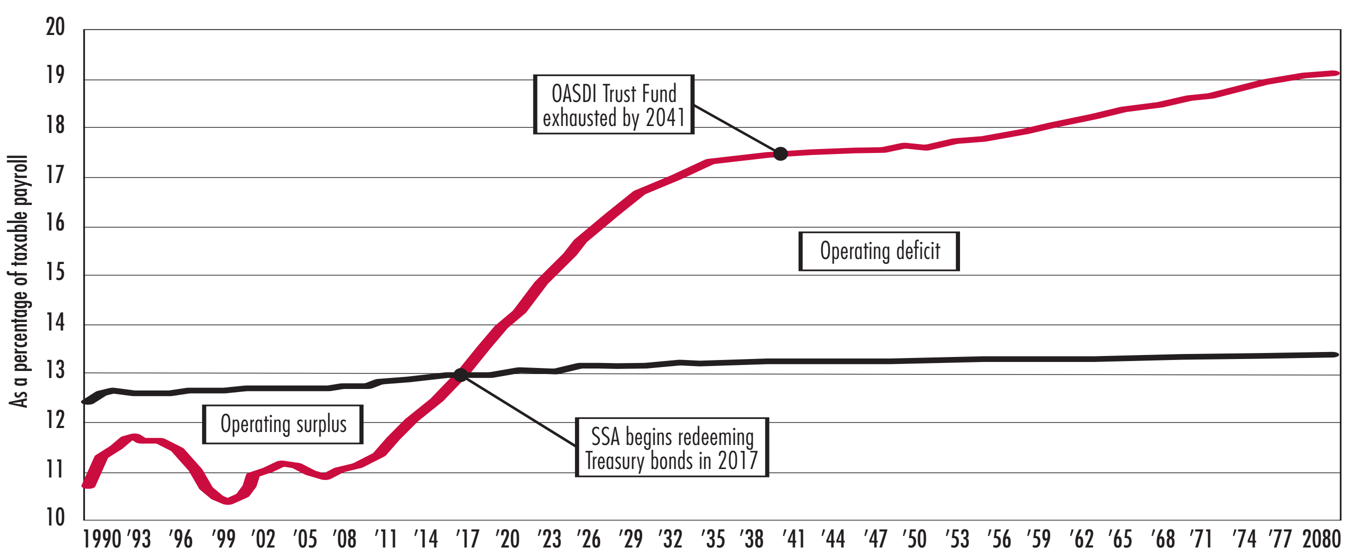
The rate of productivity growth determines how much richer each generation will be than the one that preceded it. At 2 percent productivity growth, each generation will be almost twice as wealthy as its predecessor; with 1 percent growth, only about one-third again as wealthy; and below that, not much richer at all. Future entitlements become more affordable in a high growth rate environment, and on intergenerational equity grounds, perhaps more desirable.

So President Bush, like President Clinton before him, proposes to resolve Social Security's long-term solvency problem. And, like the late Sen. Daniel Patrick Moynihan, for decades the intellectual leader of the Democratic Party on social insurance issues, he proposes to modernize Social Security with an individual account component. Bush is trying to do something democracies have always struggled with: dealing with long-run problems before they become a crisis, absent immense short-run pressure (the last major Social Security reforms were passed in 1983 under pressure that Social Security checks might have had to be delayed).

By far the most important issue is to put in place, sooner rather than later, reforms that gradually and cumulatively bring projected future benefit growth in line with projected future revenues without a tax increase. Waiting several decades to deal with the issue raises the prospect of a 50 percent increase in payroll taxes or abrupt benefit cuts.

Figure 1

Social Security Income and Cost (% of taxable payroll, historical and projected)



Source: OASDI Trustees Report, 2005

Two Myths About the Cuts in Guaranteed Benefits: "Cuts" and "Guaranteed"

Critics of Social Security reform claim there will be massive cuts in guaranteed benefits. In reality, nobody's benefits need to be cut and nobody's taxes need to be raised. Current tax rates, given projected economic growth, are sufficient to deal with the demographic deluge (or with doubling of real benefits, but not both). The current benefit formula implies real Social Security benefits per recipient will double in the next few decades. This occurs because:

1. The formula used to calculate the initial level for a retiree's Social Security benefits is indexed to wages rather than prices. From 1960 to 2004, the average wage index rose 1.1 percent per year faster than consumer prices as measured by the Consumer Price Index (CPI).
2. People will be living longer, which increases the present value of total lifetime Social Security benefits.
3. The change in the CPI, which indexes Social Security benefits post-retirement, overstates inflation by 80 to 90bp/year despite some valuable improvements made by the Bureau of Labor Statistics.[1]

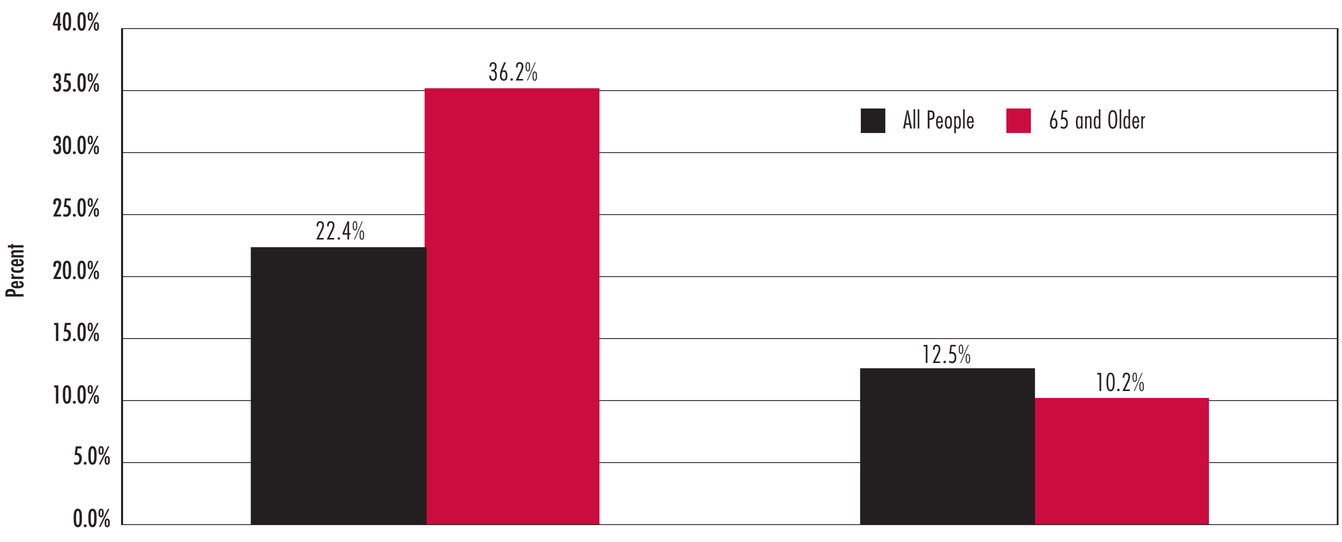
The claims that guaranteed benefits will be cut and promises broken are relative to projecting the current benefit formula forward indefinitely. However, the Social Security Administration sends future beneficiaries an annual statement which clearly states that the current system cannot pay such benefits; in a few decades, under current law, there will be only 74 cents in taxes coming into the Trust Fund, from which benefits must be paid, for every dollar of projected benefits. Further, Congress has often changed benefits in the past, most recently by taxing them, and is certain to do so in the future. There is nothing "guaranteed" about the benefits; they involve immense economic, demographic, and political risk.

Clearly there is a continuum in any notion of political promises: Current retirees and those soon to retire have based their finances on the current Social Security system, whereas younger workers and those not yet working have done much less, if any, planning for retirement and do not expect to receive the benefits in current projections. Thus whatever political promises are deemed to exist have, and should have, great force for older workers and near-retirees, less force for middle-aged workers, and little force for younger workers.

Attaining Solvency: Part A of Reform

There is a set of commonsensical reforms that would strengthen and modernize Social Security, improve incentives, and eliminate the drag the uncertainty over future funding causes for families and the economy. First, we should switch from wage indexing to price indexing, but raise benefits more rapidly for people below the poverty level. This would eliminate most of the long-term insolvency, but do so in a manner that leads to rapidly rising real benefits for people with low incomes, and more slowly rising real benefits for people with higher incomes. Next, we should prospectively increase the retirement age in several decades slightly beyond that in current law, while maintaining a strong early retirement option. Combined with a somewhat more accurate CPI (the BLS' chained-CPI), these reforms will deal with the long-run solvency issues. And they will finally fully deliver what is Social Security's

Figure 2
Poverty Rates, Elderly and General Population



Source: census bureau, poverty tables

[1] *On the change in the CPI overstating inflation, see Boskin, et al. (1998) and Lebow and Rudd (2003). Thirty or 40bp of this bias would be eliminated if and when the BLS moves to its far more accurate chained-CPI as the official measure of consumer inflation.*

most important mission, as stated at its inception by President Franklin D. Roosevelt, providing "the average citizen protection against poverty-ridden old age."

There is a strong economic, not just budgetary, reason why it is not sensible to carry a benefit formula deriving from an age of vastly different demography, economics, and household finance into the indefinite future. Economists use a term called the diminishing marginal utility of income to express the notion that as we get richer, the incremental value of yet more income declines. Thus, providing insurance against poverty is worth a great deal, and as Social Security benefits get larger and larger, their value rises more slowly.

Individual Accounts: Part B of Reform

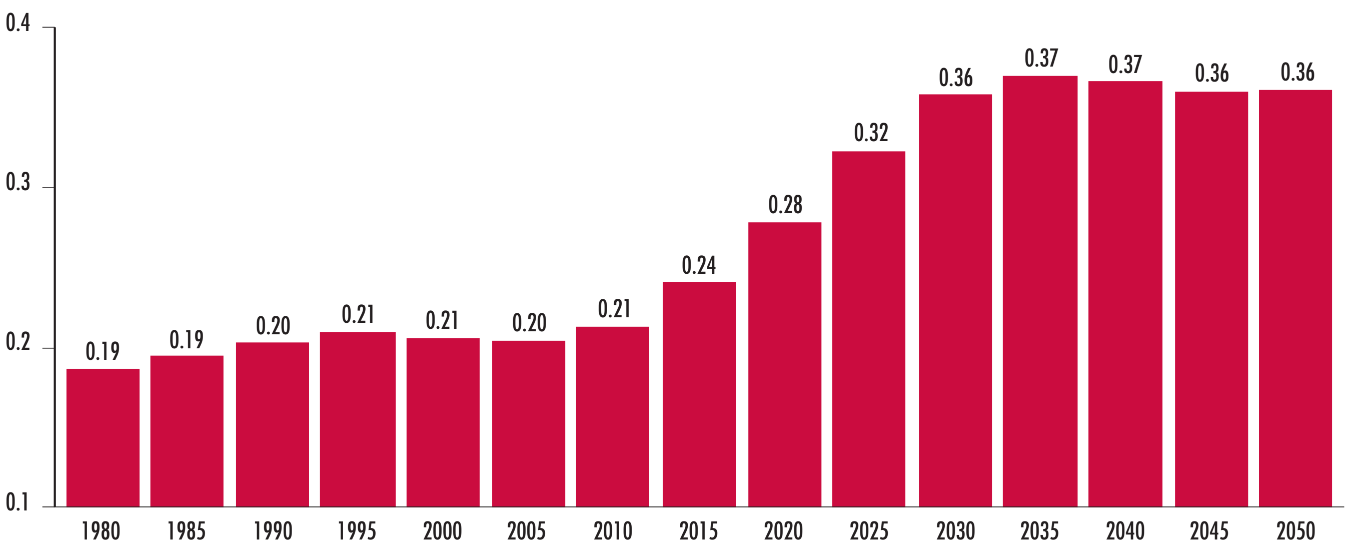
Finally, we should add an individual accounts component to Social Security, call it Part B, whereby younger workers can put a modest portion of their payroll taxes up to a limit into a broadly diversified, low-cost index fund. When funds are withdrawn, there would be a partial offset in traditional Social Security, thus keeping the sum of the two systems in long-run balance.[2] Like the other reforms, individual accounts should be phased in gradually over time. Society will be better off if virtually everyone in the population is an investor as well as a worker, consumer, and eventual benefit recipient.

Many critics of individual accounts denounce the idea of borrowing to finance them. While I share concerns about large deficits in prosperous peacetime, there is a fundamental difference between borrowing to finance individual accounts and borrowing to fund general government consumption. That borrowing passes the bill for paying for the current generation's consumption to future generations. However, the individual accounts acquire real assets. So, while there is borrowing by the government on the one hand, it finances investment in real assets on the other, like borrowing to buy a home, not to throw a party. If the federal government, like private businesses, kept separate capital and operating budgets, no change whatsoever would show in the operating budget balance. In short, while the government borrowing passes liabilities to future generations, assets are passed along as well.

Proponents of individual accounts rely on arguments of a substantial increase in saving, improved economic performance, higher returns from some of the funds being invested in equities, etc. These arguments are correct, but not without caveat. Not everyone will save more. Some people will adjust their other saving, so the full amount of saving in the individual accounts will overstate the total amount of incremental saving. However, working in the opposite direction is the fact that it will be much harder for the government to get its hands on the funds and spend them, as it has done repeatedly with Social Security surpluses for decades under administrations and Congresses of both political parties. Thus, in this sense, individual accounts may be more, rather than less, likely to increase national saving. The equity argument is correct in expected value, but clearly the excess returns to equities are payment for taking on added risk, although that risk is mitigated considerably by the required broad diversification in index funds and the long-term nature of the investment.

The biggest concern with individual accounts is one its opponents seldom raise: the growing future political power of the elderly may eventually result in at least a partial cancellation of the offset against individual

Figure 3
Old-Age Dependency Ratio (Persons Aged 65+ / Persons Aged 18-64)



Source: Census Bureau

2 *See the President's Commission (2001) for detailed discussion of offsets.*

account income, thereby turning the debt-financed ex ante "carve out" subsequently offset by traditional Social Security into an ex post "add-on" financed by taxes on future workers.

It is very unlikely that adding Part B will lead to anybody's benefits being less than they would have been if the system described in Part A — call it the sustainable traditional Social Security system — had been in place. It is likely that most younger workers will eventually receive more from the sum of their individual account income and traditional Social Security than they would in the end have received from the unsustainable current system. It is true that there is a remote possibility that there might be some individuals, even in broadly diversified mutual funds invested for a long time, whose returns could be less than if the investment had been in very safe assets, such as Treasuries. But, even in the remote possibility that the benefits would be less, they are almost certain to be only slightly less.

Bad Ideas from the Left and the Right

There are (at least) two terrible ideas being floated in the reform debate, one from the left and one from the right. First, raising or removing the cap on the amount of earnings subject to payroll taxes for Social Security would greatly increase the marginal tax rate on the most productive group in the population. This would undo all the good and then some from the President's reduction in marginal income tax rates. Such a move would end any presumption that the Social Security system is an insurance system. Whenever the cap has been raised before, additional benefits were paid based on the taxed earnings. Severing the link between benefits and taxable earnings would be a huge conceptual step, making the tax/transfer, or welfare, component of Social Security far more explicit. This risks its political support, which has been predicated on it being viewed as social insurance, not welfare. But even more fundamentally, why would we want to raise taxes on well-off workers to fund higher benefits to well-off retirees? If there is an argument that the Social Security system should be made even more progressive, it is far more properly focused on the benefit side rather than the tax side.

Second, some proponents of individual accounts argue for issuing government recognition bonds for the massive unfunded liability. They argue this just makes implicit promises explicit. If recognition bonds were a much smaller amount and if we thought people had expected the bulk of the extra benefits they make explicit, it might make sense to run a small-scale experiment, because the risk of being wrong is low and the consequences small. But that is not the case. Further, younger workers continually say that they do not expect to receive any Social Security benefits when they retire. So it is likely that a considerable fraction of the bonds would be unexpected, and the large increase in perceived wealth might result in an inflationary spending boom. Making projected future benefits explicit locks in a large, at least partly unnecessary, expansion of government to the detriment of the economy.

Why Act Now?

A favorite question of critics of reforming Social Security is: Why act now, when there is no problem let alone crisis? The first baby boomers will begin to retire in three years. The fraction of voters receiving benefits will increase 50 percent in 20 years, and double in 50, relative to the fraction of voters paying taxes, making reform ever more difficult. And, once delayed, reform is ever more likely to lead to vastly higher taxes without slower benefit growth.

With reform now, by the time the demographics really bite in two or three decades, the solvency problem will be solved and families and the economy will have time to adjust gradually without severe disruption. If we wait and make changes abruptly, with gigantic tax increases or benefit cuts or some combination all at once, wrenching adjustments would be required for beneficiaries, taxpayers, and the economy. Thus, reform really is urgent. Enacting these sensible reforms now would strengthen the economy, spare future retirees and taxpayers disruption in their personal finances, and ensure Social Security plays an important and appropriate role in future retirement income security.

A shorter version of this article appeared in The Wall Street Journal on March 30, 2005. A somewhat longer version appeared in The Economists' Voice on April 15, 2005.

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are underwritten by a generous grant from the Taube Family Foundation.

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